BANKING THEORY
AND PRACTICE

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PREFACE

THE purpose of this book is to discuss thoroughly and in an interrelated manner, banking theory and practice. The operations of all the departments of the modern American commercial bank are discussed as well as other related financial fields, whether practice in these fields is carried on by commercial banks, as such, or by subsidiary, affiliated, or allied institutions. Emphasis is placed on the practical aspects of the banking business rather than upon theory, but sufficient banking theory is incorporated to throw in a clear light the functional aims of the practice.

The numerous well-written volumes on commercial banking now published tend to develop only sections of the entire field, some laying emphasis on banking theory, to the exclusion of practice; others upon the practical details of banking operation and neglecting banking theory; and others stressing banking history. In several volumes, certain important phases of modern banking activity are entirely ignored or treated in a few words. This volume, on the other hand, attempts to picture the entire field with sufficient detail to make it valuable not only for textbook purposes, but as a practical handbook for bankers, economists, and business men. It offers assignments for a complete college course in commercial banking practice.

The authors desire to express their appreciation for assistance rendered by numerous financial institutions, including the Philadelphia Federal Reserve Bank, particularly for its assistance in connection with the chapter on The Transit Department; the Corn Exchange National Bank and Trust Company of Philadelphia, in connection with the section on Analysis of Deposit Accounts; the Guaranty Trust Company of New York, in connection with the chapter on The Operations of the Foreign Department; and the Federal Reserve Bank of New York, for the permission to use the organization chart of that bank. The authors also desire to express their appreciation for assistance rendered them by Mr. Lewis Van Court, Treasurer of Central Trust and Savings Company of Philadelphia; Mr. Arthur W. Roberts, Second Vice-President, Continental Illionois Bank and Trust Company; Mr. William Hutt,

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LUTHER HARR,
W. CARLTON HARRIS.

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BANKING THEORY AND PRACTICE

CHAPTER I

ECONOMIC PLACE OF BANKS IN THE BUSINESS WORLD

Banking Functions.—It is an economic commonplace that modern production is characterized by division of labor and specialization. This specialization in production extends to individuals, communities, and nations, so that in comparatively few instances are any but the largest communities, occupying extensive and varied sections of the world's territory, self-supporting. The division of labor has been extended to such a degree in modern civilization that practically no object of commerce is made by the single effort of a given individual. Most of the exceptions to this general principle lie in the field of art.

Individuals render certain services which, jointly with the services of others, produce a flow of consumable goods and services; and each individual, for the satisfaction of his own wants, obtains a fractional part of the total product through the process of exchange. These exchanges now take place in markets which are world-wide in scope for most commodities. The student in banking today is so familiar with this fundamental economic principle that it seems unnecessary to amplify the general statement by lengthy illustration.

Such production for extensive markets implies production on a large scale. Large-scale production prolongs the period of production. While this statement may seem inconsistent with the fact that modern machine methods can produce goods more rapidly than older methods of relying more directly upon hand labor, nevertheless the statement that large-scale production lengthens the time period involved is true because it applies, not to the last stage of that production, resulting in consumable goods, but to the entire period involved in the production of the machinery which aids in the final step; so that the construction of a locomotive is not merely the assembling of the parts but involves a long-drawn-out series of operations. The beginnings of these operations may be extended backwards almost indefinitely, but for purposes of illustration they may begin, let us say, with the produc-

tion of the machinery by which iron ore is converted into machinery, which in turn produces the parts necessary to the final assembling of the complete product. As one writer has expressed it, "*The modern method is first to expend time and energy in the preparation of tools and machinery, and then to use these to produce a larger output than would have been possible without them.*"

Consumption, however, cannot be postponed to meet this postponement of the ultimate production of consumable goods. Workers require sufficient nourishment each day, clothing necessary to meet social custom, and houses in which to live. It is, therefore, necessary to have a fund of such consumption goods available for their use during the time period involved between the origin of the effort and its ultimate result in consumable goods. This fund necessary to bridge that time period is known as *capital*. This is not intended as an economic definition of *capital*, which would be out of place in a technical work on banking. It is only used for illustrative purposes. The term *capital* also covers the material and equipment used by the workers in the production process. Generally speaking, our banking system, as a whole, is organized for the purpose of supplying this *capital* or rather making it available for use. It is, of course, obvious that the banks do not supply the material goods used in the illustration above. They supply the funds with which such goods are procured, the goods, themselves, of course, resulting from the application of labor to the raw materials of the earth. *Capital*, here, therefore is considered as a store of loanable funds which may be used to further the production process. It is the duty and the function of our banking system to collect, by processes which will be described later, these loanable funds and to make them available to the business world for productive purposes.

It has been customary, as a matter of convenience, to divide the concept of *capital* into two parts, (*a*) *fixed capital*, and (*b*) *working capital*. The line of demarcation between *fixed capital* and *working capital* is not sharply defined, but, in general, the term *fixed capital* is applied to those tools and material equipment of industry which can be utilized for a considerable period of time in the productive process before they wear out and disappear, whereas the term *working capital* applies to those materials utilized in the productive process which have only a very temporary life and in most cases are consumed in production in a very short period of time.

The distinction is important, because it is used as the basis of a separation of banking functions, two classes of banking institutions having grown up—one to supply, primarily, funds for *fixed-capital*

purposes, and the other to supply, primarily, funds for *working-capital* purposes to the business world. Just as the line of demarcation between fixed and working capital is not sharply defined, so the line of demarcation between these two classes of banking institutions is not sharply defined and a considerable degree of overlapping occurs.

The capital funds by which the capital goods are made available are created by saving. Money is the medium of exchange today, and is the form in which most income is received. The saving process, therefore, is generally one of saving money; in other words, to refrain from consuming the entire money income over a given period of time and placing it in productive work, generally through the intermediation of the banking system. The creation of capital funds, therefore, involves two steps, first, *saving money*; second, *investing it.* No capital comes into existence if the first process of *saving* is not followed by the second process or step of *investment.* Hoarding money, for example, adds nothing to the capital supply.

From these considerations there emerges the first great economic function of the banking system. It stimulates saving, gathers together the amounts saved, and promotes the productive operations of the world by lending these funds to the producers, to enable them to procure, therewith, the material goods and services required in the productive process. Some idea of the extent to which the banks of this country perform the function outlined above may be gathered from a consideration of the following figures:

TOTAL RESOURCES OF REPORTING BANKS IN THE UNITED STATES, ALASKA, AND INSULAR POSSESSIONS, AS OF JUNE 30, 1924–1928 *

(In thousands of dollars)

Type of bank	1924	1925	1926	1927	1928
National . . .	$22,565,919	$24,350,863	$25,315,624	$26,581,943	$28,508,239
State (commercial)	14,816,011	15,979,238	16,579,656	16,564,988	16,291,003
Trust companies	10,323,777	11,565,549	12,205,196	13,994,756	15,230,896
State and trust companies	25,139,788	27,544,787	28,784,852	30,559,744	31,521,899
Mutual savings . . .	7,364,656	7,913,039	8,422,307	9,011,185	9,688,159
Stock savings	1,923,384	2,093,125	2,196,427	1,815,538	1,707,197
Mutual and stock . . .	9,288,040	10,006,154	10,618,734	10,826,723	11,395,356
Private	150,943	155,223	174,152	164,148	148,834
Totals	$57,144,690	$62,057,037	$64,893,362	$68,132,558	$71,574,328
Number of banks reporting	29,348	28,841	28,146	27,061	26,213

* Annual Reports of the Comptroller of the Currency, Washington, D. C.

With the exception of the bank building, furniture, and fixtures with which the bank carries on its own operations, and the cash and legal reserves required, all of these resources are advanced by the banking system to the business world. The direct advances, in the customary forms in which they ordinarily appear, are indicated by the following table of Loans, Discounts, and Investments for the year 1928:

LOANS, DISCOUNTS, AND INVESTMENTS OF ALL REPORTING BANKS IN THE UNITED STATES, ALASKA, AND INSULAR POSSESSIONS, 1928 *

(In thousands of dollars)

	Loans and Discounts	Investments	Total Loans, Discounts and Investments
National	$15,144,995	$7,147,448	$22,292,443
State (commercial)	9,450,337	3,542,177	12,992,514
Trust companies	8,298,341	3,874,652	12,172,993
State and trust companies	17,748,678	7,416,829	25,165,507
Mutual savings	5,511,918	3,750,591	9,262,509
Stock savings	1,049,969	427,987	1,477,956
Mutual and stock	6,561,887	4,178,578	10,740,465
Private	86,507	28,959	115,466
Totals	$39,542,067	$18,771,814	$58,313,881
Number of banks reporting	26,213	26,213	26,213

* Report of the Controller of the Currency (1928)

Another important economic function of the banking system is the creation of a medium of exchange. Banks do more than collect savings from the public and invest those savings in productive enterprises. By a process which will be later described in considerable detail, the banks convert wealth, existing in forms which cannot readily be exchanged, into a convenient medium of exchange. For example, an individual may own some shares of stock in some large industrial enterprise, such as the Pennsylvania Railroad, those shares of stock representing to the owner a fractional interest in the road bed, terminals, rolling stock, and other possessions of the Pennsylvania Railroad.

This is wealth to the owner, but wealth in a form which cannot be readily used in exchange to procure other commodities. That wealth in the form of Pennsylvania Railroad stock can be taken to a bank and converted by that bank into a medium of exchange which can be used to purchase capital goods to further the productive processes or to purchase consumption goods for the immediate gratification of some want.

A portion of the medium of exchange in use in this country is created directly by the government in the forms of metallic currency and certain types of paper money.

Money in Circulation in the United States, June 30, 1928, Outside the Treasury*

	Total	Held by Federal Reserve banks and agents	In circulation
Gold coin and bullion	$893,547,006	$516,519,318	$377,027,688
Gold certificates	1,513,730,839	494,582,280	1,019,148,559
Standard silver dollars	59,703,469	13,481,924	46,221,545
Silver certificates	471,726,701	87,150,089	384,576,612
Treasury notes of 1890	1,303,600	....	1,303,600
Subsidiary silver	296,318,588	18,143,494	278,175,094
Minor coins	113,843,783	2,782,752	111,061,031
United States notes	343,659,912	45,221,560	298,438,352
Federal Reserve notes †	2,001,220,305	374,787,433	1,626,432,872
Federal Reserve bank notes ‡	4,053,408	24,424	4,028,984
National bank notes ‡	680,094,556	29,882,636	650,211,920
Total	$6,379,202,167	$1,582,575,910	$4,796,626,257

* Report of the Comptroller of the Currency (1928), p. 105.

† Issued by Federal Reserve Board through Federal Reserve banks, but direct obligations of the United States.

‡ Issued by banks.

It has been estimated that less than 10 per cent of the total business of the country is financed by this medium. Over 90 per cent of the country's business is carried on by the medium of exchange created by banks in the form of check or deposit currency.

The importance and extent of the services of our banking system in creating this medium of exchange may be indicated by the following figures:

Deposits of Reporting Banks in the United States, Alaska, and Insular Possessions*

Individual Deposits, Including Dividends Unpaid and Postal Savings, as of June 30, 1924–1928 (in Thousands of Dollars)

Type of bank	1924	1925	1926	1927	1928
National	$14,853,183	$16,354,912	$17,092,412	$18,239,353	$19,300,433
State (commercial)	11,755,233	12,682,753	13,158,075	12,936,590	12,725,135
Trust companies	7,785,331	8,536,860	8,900,928	10,094,485	10,874,503
State and trust companies	19,540,564	21,219,613	22,059,003	23,031,075	23,599,638
Mutual savings	6,693,246	7,146,951	7,577,504	8,077,099	8,672,823
Stock savings	1,746,609	1,918,230	2,021,614	1,661,803	1,561,218
Mutual and stock	8,439,855	9,065,181	9,599,118	9,738,902	10,234,041
Private	120,519	126,236	131,763	123,224	110,586
Totals	$42,954,121	$46,765,942	$48,882,296	$51,132,554	$53,244,698
Number of banks reporting	29,348	28,841	28,146	27,061	26,213

* Annual Reports of the Comptroller of the Currency, Washington, D. C.

The bulk of these deposits can be converted into currency by the process of drawing checks against them and in the course of a given period of time are used over and over again, as indicated by the following tables showing clearing figures:

Bank Clearings

	1924	1925	1926	1927	1928
Average Daily Clearings, Years Ended Sept. 30, 1924–1928					
New York City	$774,666,609	$913,775,362	$968,459,891	$1,013,724,855	$1,217,550,022
All reporting clearing houses	1,443,349,000	1,662,167,000	1,763,958,000	1,789,327,000	2,016,439,000
Total Clearings Sept. 30, 1924–1928					
New York City	$235,498,649,045	$276,873,934,638	$293,443,346,915	$307,158,631,043	$368,917,656,000
All reporting clearing houses	438,778,113,000	505,298,883,000	536,243,351,000	543,955,530,000	612,997,457,000

In addition to the main functions above discussed, modern banks through their several departments perform many incidental services, some of which may be suggested at this point: (*a*) safeguarding of money and valuables; (*b*) the execution and administration of corporate and individual trusts; (*c*) insuring titles to lands and aiding real-estate transfers by providing facilities for searches and settlements;

(*d*) the care of securities, including their purchase and sale; (*e*) business advice; (*f*) the collection and dissemination of credit information; (*g*) operations in foreign exchange. These activities will be described in detail later. The purpose of mentioning them at this point is to give a general picture of the major services which the banking system renders.

Classification of Banking Institutions.—Chief emphasis has been laid upon the function of banking institutions in respect to the part that they play in assembling and distributing capital. This capital function is performed, in part at least, by a large number of other financial institutions which are not called banks, but whose activities will be discussed because of the part played by them in that essential banking function.

The term *bank* seems to be reserved for those institutions which receive deposits, the chief exceptions being Morris Plan banks, which do not, at least in Pennsylvania, receive deposits in the ordinary form; and the Federal Land banks and Joint Stock Land banks. These latter are recent legislative creations and probably illustrate the fact that the modern conception of banking is turning toward the major function of banks as institutions for supplying capital, and turning away from the older conception of banks as institutions for the safeguarding and handling of money.

Considering the institutions to which the term *bank* is directly applied, it has been customary to classify them into commercial banks, savings banks, and investment banks.

a. Commercial Banks.—The emphasis in commercial banking is placed upon the furnishing of loanable funds for working-capital purposes, and the creation of a medium of exchange by issuing notes, collecting and creating deposits, and making them available for currency use by honoring and collecting checks. These activities will receive detailed treatment in later chapters. The commercial banks are the national banks, state commercial banks, and the banking departments of trust companies. Commercial banks engage in numerous other activities and also enter extensively into the investment field.

b. Investment Banks.—These act primarily as intermediary institutions, financing new enterprises chiefly by the sale of securities to the investing public, although to a considerable extent the capital of the investment bank is also involved of course. Such investment banks are primarily represented by the large private bankers, and others operating in one particular field, such as the Federal Land banks and Joint Stock Land banks.

c. Savings Banks.—These banks collect funds through the receipt of savings deposits and invest these funds in capital securities, thus advancing them to business enterprises. They, too, are intermediary institutions, but their relationship to the depositor on the one hand and to the business enterprises on the other tends to be a permanent one through their obligation to repay the savings deposits when called upon to do so, and to pay interest on them in the meantime, and through their relatively permanent ownership of the securities purchased.

While this classification of banking institutions has some justification and is useful as far as it goes, the present complexity of our banking organization requires a larger and more detailed classification.

Financial institutions whose activities may properly be included under the general term *banking* have shown two tendencies in developmen ; integration and specialization seem to have taken place at the same time. While specialized institutions have gradually been organized to take over outlying financial activities on the fringe of commercial banking, the larger commercial institutions at the same time have been absorbing additional activities and adding to their range. The term *department store banking* has come into use to indicate the fact that under one corporate head, and within one building, almost any financial service may be obtained. Several illustrations of the operation of these two diverse tendencies of growth may be given. Trust activities had their inception in the insurance—particularly the title insurance—business. Later, these two functions became separate and distinct, until they were both taken over by the commercial banks. Today, trust companies, or title-insurance companies carrying on business apart from commercial banking are practically unknown. In the same way, the large commercial banks have absorbed to a considerable degree the safe deposit business. They have savings fund departments carrying on the operations of a savings bank. They enter the field of investment banking, join underwriting syndicates, and buy and sell bonds as a business and not solely for investment. At the same time that the large commercial banks thus have been absorbing outlying activities in the general banking field, they have been surrendering certain of their functions to specialized institutions. Advancing funds on assignment of open book accounts —originally an activity of the commercial banks—has been taken over to a large extent by commercial credit companies. A large part of the mortgage business has been taken over by mortgage companies

and building and loan associations. Specialized institutions have grown up for the financing of cattle, for the financing of instalment sales, etc.

The mutual operation of these two diverse tendencies has created a situation of extreme complexity from the standpoint of classifying the financial institutions and fitting them into their proper place in the financial structure. Most writers have made no effort to so classify them, but have confined themselves to enumerating the institutions and describing their activities. Indeed, it must be recognized that any classification is provisional in its character; border lines must be crossed in innumerable instances, and the overlapping of functions constantly occurs. This must be the case when it is realized that the institutions have developed in accordance with no considered plan, but have added to their activities or abandoned them solely from the standpoint of local expediency, and with an aim directed primarily to profits. In many instances, legislation has intervened and served to limit or define the extension of activities along certain lines, but the legislation, itself, has been generally directed by expediency, and has not been influenced by any carefully thought-out plan for a division of the field.

The following classification is based on a note by W. H. Steiner, "The Classification of Financial Institutions," published in the *Journal of Political Economy*, February, 1922. The first chart showing the classification of Private Financial Institutions is substantially the classification made by Mr. Steiner, with some additions and changes by the authors.

As a basis for classification there are a number of possible criteria which might be used. For example, institutions might be classified on the basis of whether their ownership and management is public or private in nature. Again, they might be classified on the basis of the use to which the credit they supply is put—in other words, whether their activities are related to the commercial or to the investment field. Third, they may be classified in accordance with the nature of their operations.

Before considering a new classification of banking institutions, it is necessary to say a word or two about certain activities of banks which will not be included in the classification. Some of the activities of our banks are not banking functions at all, and their growth and inclusion in the banking fields have been to some extent accidental. Among the more obvious of these activities is the trust business, which is essentially a legal function carried on today not only by banks but

by lawyers and private individuals as well. Such also is the title insurance business, and the safe deposit business, so far as it applies to the safeguarding of papers and other valuables, as distinguished from the safe-keeping of money. The classification suggested will be based upon first, the mode of operation of the institutions included, and, second, upon the uses to which the funds which they supply are put. The classification of institutions based upon their public or private character will be reserved for separate consideration.

Under the term *methods of operation* it is obvious that minute consideration to trifling differences cannot be used as a basis for classification, but only the methods of operation in a general way, considered in relation to function. These so-called methods of operation are threefold in their nature.

a. By Means of Deposits.—Loanable funds are collected by the corporations in question, generally called banks, from individuals or corporations who are called depositors, and these deposits are applied by the financial institutions in various economic directions, either by lending or by purchasing investment securities. The commercial banks, to a considerable degree, by a method which will later be described, create deposits as well as collect them from outside sources. The financial institutions, by this mode of operation, stand as an intermediary between those from whom they receive deposits and those to whom they make advances.

b. By Means of Mediation.—Certain financial institutions are engaged in purchasing and selling securities without the deposit relationship arising. Each purchase and sale is distinct and with its completion ends the relationship between the purchaser and seller. Under the deposit and loan arrangement, however, the relationship tends to be continuous. This operation by means of mediation may, in turn, be subdivided in the following ways:

1. The mediation may be in the form of simple brokerage, where the financial agent takes no responsibility, does not use its own funds, and operates simply on a commission basis.

2. The mediation may be in the form of purchase and resale in which the funds of the financial institution are temporarily applied by the purchase and recovered again for further use by the resale. In this instance, however, the resale carries no obligation on the part of the seller. In other words, there is no guaranty or indorsement involving guaranty of the securities so sold.

3. A method of mediation may be adopted which is quite similar

to the second method above described, but which in addition involves on the part of the banking institutions acting as intermediary a guaranty of the ultimate payment of the securities dealt in.

4. The financial institution may purchase securities and resell not the securities purchased, but its own obligations, using as a rule the purchased securities as collateral security to assure the payment of its own obligations.

c. By Means of Surety.—In this mode of operation, no funds are supplied by the financial institutions, nor are any obligations dealt in, but credit is merely guaranteed or insured, so that if the original debtor fails to make payment, the organization which guarantees or insures the credit makes it good.

These three fundamental methods of operation may be applied either in the commercial or the investment fields, or in both. Therefore, the second general standard of classification, namely, the use to which the funds are put, may be simultaneously used with the first method of classification, namely, the mode of operation. It is necessary to point out that a classification based upon these considerations relates only to the general nature of the activities of the institutions involved. The lines of division, far from being distinct, merge gradually into one another, and overlap in various directions, so that, for example, the commercial banks will appear in a number of places in the classification, and comparatively few institutions so narrowly limit their operations that they will appear but once.

The table on page 12 attempts to picture the principles set forth above.

The activities of the institutions herein mentioned will be described in considerable detail in later chapters in this book, but a word or two of description concerning each of them for the purpose of explaining their place in this classification will be made here.

Deposit Method of Operation. *a. Commercial.* Commercial Banks. —It is to be noted that commercial banks appear at only two places in the table. Properly, they might appear under numerous categories in the classification, for to a greater or less extent they will perform many of the services therein described. For example, they lend extensively in the investment field, as well as in the commercial. They buy and sell securities without indorsement. They accept drafts drawn upon them and occasionally purchase them. They deal in mortgages, occasionally taking large mortgages and selling fractional parts thereof to the public, in that regard practically duplicating the operations of mortgage companies. It is for the purpose of avoiding confusion that

CLASSIFICATION OF PRIVATE FINANCING INSTITUTIONS

Method of operation	Commercial	Investment
Deposit	Commercial banks	Commercial banks Savings: Mutual Stock Cooperative institutions: Savings and loan associations Building and loan associations Private bankers
Mediation:		
1. Pure broker (buys and sells on commission)	Foreign exchange broker Notebroker (commercial paper house)	Stock broker Mortgage broker
2. Buy and sell *without* indorsement	Commercial paper houses Acceptance dealer	Investment banker Mortgage company
3. Buy and sell *with* indorsement	Cattle loan company (feeder loans)	Mortgage guaranty companies Cattle loan company (stocker loans)
4. Buy securities and sell own obligations	Foreign exchange dealers Discount company, including company financing wholesale marketing of automobiles	Mortgage companies Joint Stock Land banks Morris Plan banks Remedial loan associations Instalment financing company, including financing of retail sale of automobiles, furniture, pianos, etc. Investment trusts, including Edge Act corporations
Suretyship	Acceptance houses, including Edge Act corporations Credit insurance companies	Mortgage guaranty company

CLASSIFICATION OF PUBLIC FINANCIAL INSTITUTIONS

Method of operation	Commercial	Investment
Deposit	Federal Reserve banks	Postal Savings System
Mediation:		
4. Buy securities and sell own obligations	Federal Intermediate Credit System	Federal Farm Loan System Federal Intermediate Credit System

they are incorporated in this classification only in the fields of their major activities.

b. Investment. Commercial Banks.—See above.

Savings Banks.—By means of deposits, savings banks gather funds from the public and invest those funds in securities, thus advancing them in the investment field. The savings banks are divided into mutual savings banks, and stock savings banks, depending upon their form of organization. The mutual savings banks issue no stock. All of the depositors are members of the association and are entitled to share in the profits, after the expenses are paid and a reasonable sum set aside for surplus. There is generally no direct distribution of profits other than the payment to the depositors of a rate of interest on the deposits. Stock savings banks are institutions operated for the profit of the stockholders, and profits over and above costs of operation and interest on deposits are distributable in the form of dividends to stockholders.

Building and Loan and Savings and Loan Associations.—In the investment field operating by deposits are included the building and loan associations, and savings and loan associations, which collect from the public sums generally payable to them at periodic intervals, which are in the nature of deposits, although not strictly so called, and these funds are loaned to members, generally upon mortgage security. Institutions of a similar kind may appear in some states under other titles. They are not so included in this classification because it is not desired to give the impression that a large number of different types of companies operate in this field. Their functions are roughly the same, though they may exist under widely diverse names.

Private bankers are included in this category, for they receive deposits and lend generally in the investment field, although they may, and to some extent do, lend in the commercial field; and also operate extensively by mediation, purchasing securities which they resell, generally without indorsement. In this category they are called investment bankers, and appear as such in the classification.

Operation by Mediation. Class 1. *a. Commercial.*—Foreign exchange brokers act as intermediaries between banking institutions and commercial exporters and importers, who have exhange to buy or sell. They generally operate on a commission basis, with little or no capital of their own tied up in their activities. They are middlemen, bringing together those who have foreign exchange to sell and those who desire to purchase it. Those who have exchange to sell are primarily exporters who have drawn drafts against foreign purchasers, or foreign banks on

behalf of foreign purchasers, covering the purchase price of the goods sold. They desire to realize at once on these drafts and may do so by selling them through the intermediation of the foreign exchange brokers. Those who desire to purchase exchange are bankers who wish to accumulate funds abroad against which they can sell drafts, and importers who desire to purchase such drafts to pay debts abroad arising out of the purchase of foreign goods or securities.

Note brokers act as intermediaries between banks and other purchasers of commercial paper and the business houses desirous of raising money by the issuance of their paper. Note brokerage on a commission basis alone is generally carried on side by side with the purchase and resale of commercial paper. In respect to the latter activity, the companies or firms engaged in that business are listed in another category under the title of commercial paper houses. As an illustration of the activities of note brokers, acting on a commission basis, let us suppose that a large business corporation needs a million dollars for temporary working-capital purposes. The corporation may raise the million by executing notes in convenient denominations totaling a million dollars and offering them for sale to banks and other investors through a note-brokerage house which markets them on a commission basis.

b. Investment.—Stock brokers buy and sell stocks and bonds on a commission basis for their customers. Except in the carrying of marginal accounts and in trading on their own account, their own capital is not involved in the transactions. Although performing a function related to banking in the distribution of capital funds, the business of stock brokerage has such an extensive literature of its own that it will not be treated in this volume except in so far as stockbrokers appear as borrowers from banks.

Mortgage brokers act as intermediaries between those institutions and individuals who have funds which they desire to lend on mortgage security and those who desire to borrow on mortgage security. Mortgage brokers receive compensation in the form of a commission. This business is largely operated as part of a general real-estate business, and as such will receive only incidental reference in this volume.

Operation by Mediation. Class 2. *a. Commercial.*—Commercial paper houses, sometimes called *note brokers*, operate with their own as well as borrowed capital, purchase commercial paper issued by business houses, and resell it to banks and other investors. A corporation desiring to raise a million dollars for working-capital purposes

might sell its notes to a commercial paper house at an agreed price, the commercial paper house thus assuming the risk of the sale of the paper to investors and making its profit chiefly through the resale of the paper at a higher price. Even in this case, however, the commercial paper house charges a small commission for its services. In the resale of the commercial paper, the commercial paper house does not indorse it and so guarantee its ultimate payment.

Acceptance dealers operate on a basis analogous to commercial paper houses, but specializing in the purchase and sale of acceptances, chiefly bank acceptances. An acceptance is a time draft drawn against a business house or a bank and accepted by the drawee. The purpose of such drafts is to finance the importation or exportation as well as the domestic purchase or sale of goods. If the draft is drawn against and accepted by a business house, it is called a *trade acceptance;* if drawn against and accepted by a bank, it becomes a *bank acceptance.* Such acceptances are freely bought and sold prior to maturity, and may be carried in the portfolios of commercial paper houses as well as acceptance dealers. Frequently the acceptance dealers also make a business of accepting drafts drawn against them for the accommodation of importers, exporters, or domestic traders and in that aspect of their business they appear, in this classification, under the heading of acceptance houses.

b. Investment.—Investment bankers purchase bonds or other instruments of indebtedness from business houses desiring to raise funds for fixed-capital purposes (in some cases, for working-capital purposes, also), and resell these bonds without indorsement or guaranty to the investing public. Their profit is primarily derived from the difference between the purchase price and the selling price of the bonds they market. Private bankers add this activity to those described above under that heading, and many commercial banks, either directly, or through a subsidiary company, are operating in this field.

Mortgage companies are investment bankers, specializing in the sale of bonds secured by first mortgages on real estate. In some localities there are companies selling bonds secured by second mortgages. These bonds are not to be compared with bonds secured by mortgages on road beds, terminals, etc., issued by railroad companies. Such bonds are distributed ordinarily through the intermediation of the general investment bankers. The mortgages here referred to are occasionally mortgages on private residential property, but are generally mortgages on buildings used for commercial purposes, chiefly office buildings, hotels, and apartment houses. The construction of an office

building in a large city may be partially financed by a mortgage of $2,000,000 drawn in favor of a mortgage company which advances to the promoter the $2,000,000, less its commission and other charges. Bonds will be executed by the mortgagor in convenient denominations totaling $2,000,000, secured by the mortgage, and these bonds are sold to investors, the mortgage company recovering by the sale the amount advanced and its profit. The mortgage company records the mortgage and retains it as trustee for the bond holders. Beyond its duties as trustee, the mortgage company does not guarantee the ultimate repayment of the bonds. If such a guaranty is made, the activities of the company fall properly under the head of mortgage guaranty companies in a later subdivision of this classification. At least one of the large mortgage companies in the United States has in recent years enlarged its activities by engaging in the business of buying and selling bonds other than the mortgage bonds herein described.

Operation by Mediation. Class 3. *a. Commercial.* Cattle Loan Companies.—Specialized companies have come into being for the purpose of financing certain phases of the cattle industry. Prior to the sale of cattle by ranchers to the packing houses, there is a period of time during which the cattle to be sold are fattened for market by special feeding. The expenses incident to this period are sometimes met by loans to the ranchers made by cattle loan companies. As security for the loan the ranchers mortgage the cattle to be fattened and sold, and execute notes in favor of the cattle loan companies. The notes are indorsed by the cattle loan companies and sold to banks and other investors in short-time securities. These notes differ from the commercial paper marketed by commercial paper houses, not only in the purpose for which they are created, but also in the fact that the notes sold by the cattle loan companies are indorsed and hence guaranteed by the company. Fattening for market is considered a commercial activity and therefore cattle loan companies in respect to this type of loan (called a *feeder loan*) are classified in the commercial field.

b. Investment.—Cattle loan companies make loans of other types to ranchers. They will lend money for the purpose of supplying the rancher with funds to stock his ranch with cattle (*stocker loans*). Here also, a mortgage on the cattle will be the chief security, and the rancher will execute notes which will be indorsed and resold by the cattle loan companies. But the notes will have a longer term and may be renewed one or more times, and the funds to repay the loan may be procured by the sale of the cattle purchased; hence, this activity is classified as investment rather than commercial lending. The same

may be said of the *dairy loans*, where the funds advanced by the cattle loan companies are for the purchase of dairy cattle, and the funds for repayment are procured over a longer period of time from the sale of dairy products.

Mortgage Guaranty Companies.—These companies, whether operating under that name, or under the name of mortgage companies, differ in their activities from those described above under the title mortgage companies only in the fact that here the companies guarantee the payment of interest and principal of the bonds they sell. Some companies may sell at the same time either guaranteed or unguaranteed issues, at the option of the purchaser.

Operation by Mediation. Class 4. *a. Commercial.*—Foreign exchange dealers operate in the commercial field, and their method of business is to buy foreign exchange from industrial and commercial exporters and sell their own obligations in the form of drafts on foreign banking institutions to importers, and others, who have debts to pay abroad. In addition to the dealers specializing in this field, this activity is extensively carried on by the foreign exchange departments of commercial banks, and by private bankers.

Discount Companies.—These companies operate under a variety of names, being sometimes called discount companies, at other times, finance companies. Their general method of business in the commercial field involves the purchase or discount of commercial obligations, whether in the form of open book accounts or notes, on behalf of those companies who wish to realize upon obligations due to them prior to maturity. The discount or finance companies obtain the funds for these advances by the issuance of their own securities, or by bank borrowing, or both.

b. Investment.—Mortgage companies.—These companies which have been listed under other categories in this classification, occasionally operate by issuing their own obligations secured by the pledge of mortgages which they have purchased from applicants desiring mortgage funds. A business analogous to this is carried on by the Joint Stock Land banks, these latter banks, however, limiting their activities to agricultural mortgages as distinguished from the companies which specialize in urban securities. The Joint Stock Land banks issue their own securities, sell them to the public, and invest the proceeds in agricultural mortgages.

Morris Plan banks obtain funds by the issuance and sale of their own securities, and lend the proceeds for consumption loans, primarily to needy borrowers. They are classified under the investment head

primarily to indicate that the proceeds of their loans are not ordinarily used for commercial purposes.

Remedial loan associations operate on various plans, most of them analogous in principle to that of the Morris Plan banks. Instalment financing companies are properly classified in both the commercial and investment fields, depending upon the use of the funds which they advance. In so far as these companies finance instalment sales to retailers, they are properly classified in the commercial field, but in so far as they finance the retail purchase of automobiles, furniture, pianos, etc., they are classified in the investment field.

Investment trusts obtain funds by the flotation of their own securities and invest those funds in the purchase of domestic and foreign stocks and bonds. Edge Act corporations, in respect to one field of their activities, are investment trusts operating exclusively in the foreign field, and under Federal charter.

Operation by Suretyship. *a. Commercial.*—Turning to the method of operation by means of surety, financial institutions which operate in the commercial field are acceptance houses, which do not advance funds, but only guarantee the credit of the drawer by accepting time obligations drawn against them, which are later sold in the financial markets. The purchasers of these obligations advance the funds, the acceptance house acting only in the capacity of guarantor. The amendment to the Federal Reserve Act known as the *Edge Act* authorizes, in addition to Edge Act corporations referred to above, a type of financial institution which carries on business in a way analogous to the acceptance houses herein described, confining their acceptance activities, however, to the financing of foreign trade, exclusively.

Under this category, also, may be listed the credit insurance companies which guarantee certain carefully selected and investigated credit risks, without, however, advancing any funds except as may be necessary under their guaranty in case of default of the credit guaranteed.

b. Investment.—In the investment field, certain of the mortgage companies above referred to make a practice of guaranteeing the payment of the interest and principal of mortgages without purchasing the mortgage or advancing any funds unless the mortgage debtor defaults under his obligation.

Public financial institutions in the United States have been classified in accordance with the same principles which have been applied to private financial institutions. Under the deposit method of operation, and operating primarily in the commercial field, appear the *Federal*

Reserve banks, which, although privately owned in the sense that their stock is subscribed to and possessed by member banks, have a degree of public supervision which justifies their classification as public institutions. The bulk of the funds which they advance are obtained from deposits by member banks, and under the terms of the Federal Reserve law these advances are primarily in the commercial field. The only exceptions are in the privilege accorded to these banks to purchase government securities and municipal warrants.

In the investment field the *Postal Savings System* is a public financial institution operating under the jurisdiction of the Post Office Department. These postal banks receive deposits from individuals, and utilize the proceeds either by investment in government securities or by redepositing them in banking institutions.

Operating by means of mediation in the commercial field the *Federal Intermediate Credit* banks sell their own obligations and invest a portion of the proceeds in advances to farmers and other agriculturalists for crop moving and other short-term agricultural purposes. Inasmuch as the Federal Intermediate Credit banks may also make advances to farmers for longer terms, and for investment purposes such as irrigation and the purchase of agricultural machinery and other necessary farm implements, they are also listed as investment institutions.

Operating in the investment field and by means of mediation is the Federal Farm Loan System, which carries on a business analogous in most respects to the Joint Stock Land banks, hitherto described, but because of governmental supervision is classified as a public institution.

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CHAPTER II

BANKING INCORPORATION

Banking incorporation in the United States today is free and unrestricted. In the early history of this country, banks were incorporated by special charter granted by the legislatures of the respective states; but by legislative enactments from time to time in every state of the Union, banking incorporation became a matter simply of conformity to the prerequisites set forth by the banking or general corporation laws.

Banks may operate under charters granted either by the Federal government, under the National Banking Act of 1863 and its amendments, or under charters granted by the state governments in conformity with the banking or general corporate laws of those states.

The first question to be decided by any group of individuals planning to organize a bank is whether to organize under national or state charter. It is obvious that no general conclusion can be reached as to the advisability of organizing one type of bank rather than another. It is largely a local problem, the answer depending upon local conditions. Both types of banks are constantly being organized in different sections of the country; both of them serve valuable purposes and may be equally profitable. So far, however, as any group is concerned, there may be advantages or disadvantages, appertaining to each type of institution, which will determine the decision at that time and place. The factors which would be considered in arriving at such a conclusion would be:

1. The Amount of Capital Required.—The capital requirements for the organization of national banks are given later in this chapter. Space does not permit of a complete statement of the capital requirements for state banks under the 48 state laws, but almost without exception they are materially lower than the requirements under the national system. This factor in itself may be sufficient to determine for a given group the advisability of organizing a state rather than a national bank. The difficulty of selling a sufficient amount of capital stock in a given community to meet the national requirements might be a deterring factor. Prior to the passage of the McFadden bill on Feb. 25, 1927,

another factor to be considered in respect to capital stock was the required par value. For national banks this was $100 in every case, except in the organization of a national bank to succeed a state bank, in which case permission was given to retain the par value of the state bank's stock. For state banks, lower par values were ordinarily allowed, thus permitting subscription to bank stock by individuals who might desire to invest only small sums of money, and also facilitating to some extent the resale of bank stocks, the prices permitting a wider distribution. Under the terms of the McFadden bill, however, national banks have been placed upon an equality with state banks in this respect by permission to organize now with stock of any par or to change their existing par value to any other par, so that today that factor would not be important in determining the respective advantages of state or national organization.

2. Extent of Powers.—Another factor of equal or perhaps greater importance is the extent of the powers granted to the respective institutions. These powers must be analyzed with due consideration to the locality in which the bank is to be situated, and the needs of its probable customers. Among the powers which should be carefully studied as a basis of the decision are:

a. Loans on the Security of Real Estate.—As will be pointed out in detail later on, national banks are rigidly restricted in respect to the type and amount of mortgage loans which they may extend. State laws vary, but in general the restrictions on mortgage loans are less rigid under the state than under the national system, and, in many states, no restrictions whatever are placed on the mortgage lending of banks. If, therefore, the bank is to be organized in a suburban community where a considerable part of its business will in all probability consist of mortgage loans for home building, the national bank restrictions would indicate the advisability of organizing a state bank. On the other hand, if the bank is to be organized in a settled commercial community, a consideration of the mortgage activity of that bank might be a negligible factor.

b. Limitations on Loans to Individuals.—National banks are limited in respect to the amount of loans which they may extend to individual borrowers, to a degree greater than the limitations imposed upon state banking institutions. This must not be understood to indicate that it would, therefore, necessarily be advantageous to organize a state bank. The limitation of loans to individuals operates as a factor of safety, and the very existence of such a known limitation might induce individuals to deposit with such a limited institution rather than in a

bank where loans of any size might be created at the discretion of officers or directors. If the bank to be organized is small, however, these limitations, which are calculated as a percentage of the capital stock of the bank, might seriously handicap it in granting accommodation to a few larger industrial establishments in its community. On the other hand, if its financial status enabled it to organize with a substantial capital at the outset, such limitations might have no practical disadvantage.

c. Branch Banking.—While the laws of the different states vary widely in respect to the powers granted to their banks to open branches, nevertheless some states grant extensive powers—in this respect going far beyond the permission granted to national banks to organize branches. If the organizers of the bank, therefore, have in mind an extension of their bank through the organization of branches, this is a factor which must be seriously considered.

d. Investments.—Subject to a wide diversity of state legislation, it may be said in general that state laws grant to state banks wider powers in respect to investment of the bank's funds than do national banking laws. In particular, national banks are prohibited from investing in the stocks of corporations other than the stock of a Federal Reserve bank or the stock of a corporation organized to finance foreign trade, except that a national bank may purchase and hold for a comparatively short period stock which has been pledged with it as collateral security for a loan, and which it has been compelled to purchase in order to protect itself from loss upon default of the borrower. State banks are frequently permitted to invest their funds in stock. If the bank organizers, therefore, anticipate that their bank will engage to any degree in security dealings or if they are planning the direct ownership by the bank of subsidiary companies of different types, this factor should be taken into serious consideration. However, national banks may indirectly own or control subsidiary companies in various ways.

e. Interlocking Directorates.—The Clayton Anti-trust law imposes restrictions upon national banks in respect to the election of directors who are also directors of other banking institutions. In general, state laws have nothing to say on this matter, and consequently if a chain of banks is contemplated, mutually operated by a system of interlocking directorates, state organization gives considerably more latitude in this respect than does national organization.

3. Examinations, etc.—It will be seen from this brief survey of powers that in almost every instance the national banks are more rigidly

restricted and supervised than are state institutions. It must not from this be hastily assumed that it is obviously advantageous to organize a state bank. As has been stated, these restrictions operate to increase the safety of the national banks in comparison with many of the state institutions, and that factor of safety may be utilized for advertising purposes, may add to the prestige of the national institutions, and may serve as an incentive to individuals and business houses to deposit with national banks rather than with state banks.

On the other hand, this statement is not intended to indicate that state banks are necessarily unsafe or improperly managed. An analysis of the comptroller's reports over a series of years, however, will show that the percentage of failures and losses to depositors in the national system has been considerably less than the failures and losses under the state systems as a whole. This is, no doubt, due in considerable measure to the operation of these limitations on activity, as well as other differences in degree of examination and supervision by the banking authorities.

This latter statement indicates that another factor to be considered is the relative quality and strictness of the state as compared to the national examinations of the conditions of the banks. While many of the state banking departments have a thorough and competent examination system, it would probably be fair to say that in the main the examination of national banks is more effective. The weight to be given to this factor would, of course, depend upon whether the organizers courted rigid examination for the element of safety resulting therefrom, or whether they opposed it because of the nature of the activities that they were initially planning.

4. Reserve Requirements.—All banks, whether state or national, are required by law to maintain a reserve which is calculated as a percentage of their deposits. This reserve is uniform for the national banking system throughout the country, and will be discussed at a later point. The reserve requirements imposed by the state banks vary widely from state to state. In general, however, it may be said that the state reserve laws permit of some interest return to be earned on the reserve money, whereas in the national system all of the reserves must be deposited with Federal Reserve banks, which pay no interest.

5. Membership in Federal Reserve System.—All national banks are required to be members of the Federal Reserve System. State banks are permitted to join the system if they so desire, but are not required to be members. This factor would be important depending upon the attitude of the organizers toward the Federal Reserve System and the

feeling in respect to its benefits or disadvantages, as the case might be. It is the opinion of the authors that the benefits of the Federal Reserve System outweigh any disadvantages that might be inherent to membership, but such a feeling is not universally held, and there are many banks which refrain from joining the system through what they believe to be motives of self-interest.

6. Taxation.—A minor factor to be considered is the extent to which the state and national institutions are subject to tax. National banks may not be taxed by the states in respect to their franchises or banking activities. Their property owned may be taxed under the real or personal property-tax laws of the states, and their stock may be taxed in respect to its ownership by individuals in the state. Both types of institution are subject to the Federal Income Tax laws. In general, a consideration of taxation indicates a slight disadvantage in respect to state banks.

7. Comparative Ease of Getting Charters.—While, theoretically, charters are freely granted to any individuals who meet the requirements of the organization laws, nevertheless, as an investigation to determine the advisability of organizing the bank is a feature of the national system and some state systems, the actual strictness with which such an examination is made and the nature of the interpretation placed by the respective banking authorities upon the results of that examination might be a factor of importance. A considerable number of applications for national charters are rejected as a result of the investigation. A rejection of an application to organize a state bank is more rare, in most states.

8. Note Issue.—While the emphasis upon the note-issue powers of banks is steadily declining, nevertheless in some communities it is still felt that the issuance of notes by a local bank gives prestige or publicity to the issuing institution. National banks may, under certain conditions, issue notes. State banks are practically prohibited from so doing, by the imposition of a prohibitive tax upon their issues. If the organizers, therefore, desired that their bank should issue notes, national organization would be indicated.

NATIONAL BANKING INCORPORATION

Application to Organize.—In the incorporation of a national bank, the first step is to write to the Comptroller of the Currency stating the title that has been determined upon and requesting the comptroller to reserve such title until the formal application has been filed. This ini-

tial application also states the location and the proposed capital of the bank to be organized. It is the practice of the comptroller's office to reserve the title for 15 days, but if the formal application is not filed within that time, the title can, nevertheless, be used—if some other group has not, *in the meantime, filed an application for a similar name. A title will not be allowed if it is so similar to that of another bank in* the same community that confusion between the two institutions might arise. . . . "The name of the place should form a part of the title, *e.g., The First National Bank of Philadelphia,* but the name of the state should not be included." [1]

It sometimes happens that an existing state bank is to reorganize as a national institution. A direct conversion of a state bank into a national bank can be accomplished by a method which will be discussed later; or the state bank may be liquidated and a national bank organized to take its place. In either case, the initial request for the reservation of the name should state the procedure which is to be followed.

Upon receipt of the request for reservation of a name, the comptroller will notify the applicants whether or not the name is satisfactory and, if requested, will mail to the applicants blank forms of application for charter. This application states the intention to organize a national banking association, gives its title, location, capital and surplus, and states whether it is or is not to succeed some other existing bank. It states whether it is proposed to purchase or build a banking house, and the amount to be invested in such banking house and fixtures, or, if it is proposed to lease quarters, the amount of annual rental. It certifies that no fee or commission has been paid or contracted to be paid for securing subscriptions or selling stock in the bank. It contains blank spaces for the signatures of applicants, with their residences, business, financial strength in figures, and the amount of shares to which they have subscribed; also, the other national, state, or private banking institutions with which the applicants are or have been connected, either as officers or directors. There must be at least five signatures of applicants who are prospective shareholders of the bank, and preferably those of individuals who are also to be officers or directors.

The comptroller requests that the application be indorsed by three prominent public officials of the place where the bank is to be located. Such officials, for example, may be the mayor, or other prominent executive or administrative official of the city or town; the postmaster;

[1] Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks (1926).

the judge of any local court; etc. The purpose of this is to assure the comptroller of the good faith of the applicants and that the community, itself, is, to some extent at least, in sympathy with the organization of the bank. Professional promoters are excluded for the reason that the organization of the bank should represent a strong local demand for banking accommodation, and should not represent merely a promoter's desire to organize a corporation for his own profit and then sever his connection with the bank.

In addition to the signatures of the applicants, a typewritten list of their names should be furnished, and one individual should be designated as a *correspondent* upon whom should be delegated the duty of conducting all correspondence with the comptroller's office. "The *correspondent* should be a resident of the place where the bank is to be located, a prospective shareholder, and, if possible, an officer or director of the proposed bank." [1] For the initial correspondence, " . . . printed headings on stationery of the organizing bank should indicate clearly that the bank is organizing, or should bear the heading, '*Organizing Committee.*' " [1] As the permanent stationery should contain the bank's charter number, it is not advisable to obtain such stationery until the bank is chartered, and its number ascertained. The comptroller will not reserve any special charter number.

For the same reason that dictates the exclusion of professional promoters, the organization expenses must not include commissions for the sale of stock or promotion fees. This principle applies whether or not the fees are to be payable at the time of organization or under some verbal or written agreement they are to be payable at some later time, and whether the contract was with the proposed bank or with the subscribers to the stock of the proposed bank.

For the purpose of giving the comptroller further information upon which to weigh the merits of the application, it is necessary to state whether or not any of those interested in the organization of the proposed bank have at any prior time been connected with the organization or attempted to organize any other bank, whether state or national. If so, the name of such bank or banks, and the conditions under which they were organized, must be given.

As soon as the organization has progressed sufficiently to permit of it, a list of officers and directors should be furnished to the comptroller's office.

Capital Requirements. *a. Par Value.*—Prior to the passage of the McFadden bill, Feb. 25, 1927, the par value of national bank stock was

required to be $100, unless the national bank resulted from the conversion of a state banking institution, in which case the par value of the stock of the state bank could be retained by the national banking association. The McFadden bill provided as follows:

> The capital stock of each association shall be divided into shares of $100 each, or into shares of such less amount as may be provided in the articles of association, and be deemed personal property and transferable on the books of the association in such manner as may be prescribed in the by-laws or articles of association. Every person becoming a shareholder by such transfer shall in proportion to his shares succeed to all rights and liabilities of the prior holder of such shares, and no change shall be made in the articles of association by which the rights, remedies, or security of the existing creditors of the association shall be impaired.

Since the passage of this act, a considerable number of national banks have taken advantage of its provisions by lowering the par value of their capital stock. The purpose of this has generally been to bring the market value of their stock more within the range of the average investor. Many banks, through a long accumulation of surpluses, or because of earning capacity and future prospects, find their stocks quoted at exceedingly high prices, and this, to some extent, discourages the distribution of their stock to the public. As banks ordinarily find it to their advantage to have their stocks widely held, this step in reducing the par value of the stock and consequently its market value per share, facilitates a wider distribution.

b. Amount of Capital Required.—

> National banks with a minimum capital of $25,000 may be organized in any place, the population of which does not exceed 3,000; with a minimum capital of $50,000 in any place, the population of which does not exceed 6,000; with a minimum capital of $100,000 in any place, the population of which does not exceed 50,000; and with a minimum capital of $200,000 in cities with a population of over 50,000.[1]

Prior to the passage of the McFadden bill, the requirement of a $200,000 capital in cities with a population of over 50,000 was strictly construed, and applied to the organization of a national bank at any point within the political boundaries of such a city, although the place of the location of the bank might be, from an economic point of view, a small community, for example a quasi-suburban section on the outskirts of a large city, but within its political boundaries. This inter-

[1] *Ibid.*

pretation of the act was changed by a specific provision in the McFadden bill as follows:

> No such association shall be organized, in a city which exceeds 50,000 persons, with a capital of less than $200,000, except that in the outlying districts of such a city, where the state laws permit the organization of state banks with a capital of $100,000 or less, national banking associations now organized, or hereafter organized, may, with the approval of the Comptroller of the Currency, have a capital of not less than $100,000.

c. Payment.—At least 50 per cent of the capital stock of a national bank must be paid in cash prior to the issuance, by the comptroller, of the certificate of authority to commence business. The remaining 50 per cent may be paid in five equal monthly instalments thereafter, or in any other manner that the subscribers and the directors may agree upon, provided that the full payment be made within 6 months.

All payments must be in cash. Promissory notes, or other evidences of indebtedness are not acceptable in payment of capital stock.

Investigation by National Bank Examiner.—The application to organize shall be transmitted to the Comptroller of the Currency. Formerly it was accompanied by a draft for $100 payable to the order of the comptroller to cover the expense of investigation, but of recent years this practice has been discontinued, and the examiner now presents a bill to cover the expenses of the examination.

Upon receipt of the application, the comptroller directs the chief national bank examiner for the district to detail an examiner to make the investigation. This examiner communicates with the local *correspondent* of the organizing bank and arranges a date when the investigation is to be made. The examiner will investigate.

> (1) . . . the general character and experience of the organizers and of the proposed officers of the new bank; (2) the adequacy of existing banking facilities, and the need of further banking capital; (3) the outlook for the growth and development of the town or city in which the bank is to be located; (4) the methods and banking practices of the existing bank or banks, the interest rates which they charge to customers and the character of the service which as quasi-public institutions they are rendering to the community; (5) the reasonable prospects for success of the new bank if efficiently managed.[1]

In addition to this investigation, the examiner is authorized to personally interview as many individuals as he considers advisable who may be in favor of or opposed to the organization of the bank. Some-

[1] *Ibid.*

times public meetings are held, at which all those interested in objecting to the organization may be heard, and answered by those who favor it.

As a result of this investigation the examiner files a report with the Comptroller of the Currency, either advising for or against the granting of the charter. In addition to this report, " . . . the comptroller obtains a report from the Federal Reserve bank of the district, from the state banking department, and from such other sources as he may deem advisable." [1] This investigation is not merely perfunctory, but is made with a serious purpose, and quite frequently results in a refusal to grant the charter; the refusal generally is based upon a belief that banking facilities are adequate in the community and therefore a new bank would have poor chances of success, or, if successful, would unduly weaken the position of other banks in the community. Generally speaking, it would be better to have two strong banks than three weak ones, even though the banks were state, and not national, institutions. In other words, application to organize a national bank may be refused, even though there be no other national banks in the community, if, in the opinion of the comptroller, the community is adequately served by state institutions and a new bank would introduce a factor of weakness.

Approval of Application.

If the application receives the approval of the comptroller, he will furnish all necessary blanks for use in connection with effecting the organization, with instructions for their proper execution, and the title applied for will be reserved for 60 days, during which it is expected that the organization of the bank will be completed.[1]

Subscriptions to Stock.

When the proposed incorporators have received advice of the approval of their application to organize, there may be formulated a subscription contract to be signed by the prospective shareholders which, in addition to the signatures, should give each subscriber's occupation, address, net financial worth, and the number of shares subscribed.[1]

The comptroller earnestly recommends to all organizing banks the advisability of selling the capital stock at a premium of 10 per cent or more, for the purpose of creating a surplus from which may be paid the necessary expenditures for organization, which together with the salaries of officers and employees, frequently result in an impairment of capital during the first year or two of a bank's existence.[1]

Such impairment of capital is more serious in the case of a banking institution than in that of other corporations. Under the national banking law, the impairment of capital amounts to technical insolvency, and a bank may be closed and liquidated by the comptroller if its capital is impaired, unless the stockholders, by assessment, make up the impairment. Hence, it very rarely happens that a national bank is organized without a substantial paid-in surplus, generally exceeding the 10 per cent recommended by the comptroller. For example, the City National Bank and Trust Company of Philadelphia, organized in 1927 with stock of $100 par value, sold its stock to the subscribers at $200 per share.

Where the stock is sold at a premium of 20 per cent or more, a bank is enabled at the first dividend period to distribute the net earnings without carrying any portion thereof to the surplus fund.

Where stock is to be sold at a premium to create a surplus, provision therefor should be made in the subscription contract. Provision may be made for the payment of the premium, in instalments, as in the case of capital stock payments, but in certifying payment of instalments on account of capital, payments on account of premium must be excluded.[1]

When the organization papers are drawn up and transmitted to the comptroller, the directors should submit, over their signatures, a statement showing the amounts collected on subscriptions and the expenditures which have been made from the funds collected. The balance remaining after the purchase of necessary bonds to secure circulation, if circulation is to be issued, must be deposited with some disinterested bank and the president or cashier of the depository bank is requested to certify to the comptroller the amount on deposit to the credit of the organizing bank. The depository bank should also be required to accompany the certification with a statement as to whether any part of the amount so deposited is represented by loans made to any of the subscribers to stock secured by shares of stock in the proposed national bank or other security.[1]

Temporary certificates may be issued in case subscriptions to stock are paid in instalments. When all instalments have been paid, the temporary certificates should be surrendered and canceled, and permanent certificates of stock issued in their place.

Articles of Association and Organization Certificate.—The articles of association must be signed by five natural persons, preferably the same five who signed the application to organize the national bank. Married women may be among the organizers if the laws of the state in which the bank is to be located give to married women the right to execute and acknowledge instruments and own property in their own

[1] *Ibid.*

names. If it turns out that a majority of those who made application to organize are not interested in the bank as shareholders, a new application may be required.

In addition to the articles of association, an organization certificate must be executed by the same five individuals who sign the articles of association. These two papers are executed in duplicate, one set being filed in the office of the Comptroller of the Currency and the other retained by the bank.

The organization certificate contains the name, net financial worth, and the residence of each shareholder of the association, with the number of shares held. Signatures are not desired, here, and the names should be typewritten if practicable. If the stock has been subscribed for by guardians or trustees, the right to subscribe must be shown in every case, together with the name or names of the ward or beneficiary, as the case may be. Stock subscriptions should not be taken in the name of an estate. If the subscription is made by the executor, his authority must be shown. An administrator has no authority to subscribe for stock. Subscriptions to stock should not be received in the name of any state, county, township, or municipality.

Where stock is subscribed for in the name of an order or association, it will be necessary to furnish evidence that such order or society is authorized by its articles or charter to subscribe for the stock, and also that it is legally and financially responsible for an assessment thereon in case one becomes necessary.[1]

Appointment of Officers.

The directors having been elected, made payment of at least 50 per cent on the requisite number of shares, and taken the required oath, should, as soon as practicable, elect a president, and vice president of the association, a cashier, and such other officers as may be desired.[1]

Subscription to Stock in Federal Reserve Bank.

Before the comptroller will issue certificate authorizing commencement of business, it will be necessary for the proposed bank to subscribe for stock in the Federal Reserve bank of the district to an amount equal to 6 per cent of the unimpaired capital and surplus of the association and to pay in cash an amount equal to 50 per cent of such subscription.

The application for stock is made to the Federal Reserve bank, which will pass upon it and transmit it to the Federal Reserve Board, of Washington, D. C., for approval. When the Federal Reserve Board has approved the application, the stock can then be paid for.[1]

[1] *Ibid.*

Certificate of Authority to Commerce Business.

All organization papers having been filed, the required amount of stock in the Federal Reserve bank having been subscribed and paid for, the Comptroller of the Currency, if satisfied from the examiner's report that the association has complied with the requirements of law, and that the shareholders have, in good faith, organized for the legitimate objects contemplated by the bank act, will give to the association a certificate authorizing it to commence the business of banking. This certificate, upon its receipt, must be published in a local or county newspaper for a period of 60 days, and proof of publication sent to the comptroller at the proper time.

This and other certificates referred to elsewhere may be published for the period of time required by law, either in a weekly newspaper, a weekly edition of a daily newspaper, or in every issue of a daily having no weekly edition.[1]

Commencement of Business.

The association having received authority to commence the business of banking, it is presumed that a suitable banking house or room has been secured, and also a burglar- and fireproof vault or safe. In ordering stationery, provision should be made for the printing of the charter number of the bank on letter heads. The comptroller should be promptly advised of the date on which the bank begins business. Notification blank for the purpose is furnished.[1]

Payment of Deferred Instalments on Capital.

The certificate of officers and directors is the certificate of the payment in cash of the first instalment of the capital. The five remaining instalments must also be paid in money and certified to the comptroller by the president or cashier, under seal of the bank. Instalments are due monthly from the date of the issuance of his certificate of authority to commence business.[1]

ORGANIZATION OF A NATIONAL BANK TO SUCCEED A STATE BANK

Occasionally it is deemed advisable by directors and other shareholders of a state bank to enter the national system by reorganization rather than by conversion. The controlling motive in reorganizing rather than converting in such case is generally the desire to effect such a distribution of stock as will result in the best interests of the bank, and occasionally to provide for a more satisfactory investment of capital and other loanable funds.[1]

The course of procedure in reorganizing in so far as incorporation is concerned is identical with that required in original organization of a national bank. The capital must be paid in cash and not in any assets of the bank the national bank is organized to succeed. Only 50 per cent, however, is required to be paid at

reorganization, and the remainder may be paid in instalments as provided by the National Bank Act.

Upon receipt of an application to organize a national bank to succeed a state bank, the chief national bank examiner for the district will be directed to detail an examiner to make the investigation and to arrange with the local correspondent relative to date when the investigation is to be made.

At the conclusion of the investigation the examiner will present his bill, whereupon the applicants should deliver to him draft payable to the order of the Comptroller of the Currency in the amount of the bill in order that it may be sent to the Comptroller of the Currency with the examiner's report.

The examiner will be instructed to make a thorough examination of the condition of the bank which the national bank is to succeed, and to report upon the character of its assets and the manner in which its business has been conducted. He will also be required to report upon the character and financial standing of the applicants, the ability of the active executive officers of the bank to be succeeded, whether they have the confidence of the community, and the prospect of success of the new bank.

In addition to securing a report from the examiner, the comptroller will also obtain a report from the Federal Reserve bank of the district; from the state banking department, and from such other sources as he may deem advisable.

Upon receipt of charter, the authority to begin business, the directors have authority to enter into a contract with the directors or liquidating agent of the state bank which the national bank has been organized to succeed for the purchase of assets and assumption of liabilities to depositors and other creditors of the state institution, with the understanding, however, that no assets can be acquired which are not of satisfactory value and which do not conform in character to the requirements of the National Bank and Federal Reserve Bank acts. A duly executed and properly signed copy of the contract in question should be filed with the Comptroller of the Currency, together with an agreement signed by the directors to the effect that no assets, the holding of which would contravene the provisions of the national and Federal banking laws will be acquired.[1]

Conversion of State Banks into National Banks.—The National Bank Act, as amended by Sec. 8 of the Federal Reserve Act, provides that

Any bank incorporated by special law of any state or of the United States or organized under the general laws of any state or of the United States and having an unimpaired capital sufficient to entitle it to become a national banking association under the provisions of the existing laws may, by the vote of the shareholders owning not less than 51 per cent of the capital stock of such bank or banking association, with the approval of the Comptroller of the Currency, be converted into a national banking association, with any name approved by

[1] *Ibid.*

the Comptroller of the Currency: Provided, however, That said conversion shall not be in contravention of the state law. In such case the articles of association and organization certificate may be executed by a majority of the directors of the bank or banking institution, and the certificate shall declare that the owners of 51 per cent of the capital stock have authorized the directors to make such certificate and to change or convert the bank or banking institution into a national association. A majority of the directors, after executing the articles of association and the organization certificate, shall have power to execute all other papers and to do whatever may be required to make its organization perfect and complete as a national association.

The shares of any such bank may continue to be for the same amount each as they were before the conversion, and the directors may continue to be directors of the association until others are elected or appointed in accordance with the provisions of the statutes of the United States. When the comptroller has given to such bank or banking association a certificate that the provisions of this act have been complied with, such bank or banking association, and all its stockholders, officers, and employees shall have the same powers and privileges, and shall be subject to the same duties, liabilities, and regulations, in all respects, as shall have been prescribed by the Federal Reserve Act and by the National Banking Act for associations originally organized as national banking associations.

The Solicitor of the Treasury has held that a trust company organized under state laws may be permitted to convert into a national bank under the provisions of this section, provided it complies with all the conditions of law, and divests itself of all its trust company business, except such as the Federal Reserve Board might specifically authorize it to retain as provided by the Federal Reserve Act.

In the conversion of a state bank there is not a dissolution of the state corporation, but merely a change of title and governmental supervision; the bank is liable for all obligations and may enforce all contracts made with it while a state corporation. The Supreme Court of the United States has decided that no authority from a state is necessary to enable a state bank to become a national banking association. However, under the provisions of the National Bank Act, as amended by the Federal Reserve Act, a state bank cannot be converted into a national bank if such conversion is forbidden by the laws of the state.[1]

The application to the Comptroller of the Currency for permission to convert a state bank into a national bank is essentially the same as the application to organize a national bank. The main differences are that it is made and signed by a majority of the directors of the state bank, and that the directors agree in the application to dispose of any assets of the state bank which cannot legally be held by a national bank.

[1] *Ibid.*

Examination of State Bank Converting.

Upon receipt of an application to convert a state bank, the chief national bank examiner for the district is directed to detail an examiner to make the investigation, the examiner being instructed to arrange with the officers of the bank as to the date when the examination is to be made. The examiner investigates the character and financial standing of the officers and directors, and reports on the manner in which the state bank has been managed, what the officers have accomplished in the community, and also as to the probability of the success of the bank as a national bank. The examiner is also instructed to prepare a list of the assets of the state bank that do not conform to the provisions of the National Bank Act or the Federal Reserve Act.

At the conclusion of the examination the examiner will present his bill, whereupon the applicants should deliver to him a draft, payable to the order of the Comptroller of the Currency, in the amount thereof, in order that it may be sent to the comptroller with the examiner's report.

The restrictions of law relative to excessive loans, loans secured by real estate, and stocks of other corporations, are held to apply to a state bank proposing to convert into a national association, and where assets of the character in question, lawfully acquired, are found, conversion may be expedited by obtaining an agreement signed by the directors and sent with the report to the effect that such assets will be liquidated or disposed of otherwise within a specified time.

In addition to securing the report from the examiner, the comptroller will also obtain a report from the Federal Reserve bank of the district; from the state banking department; and from such other sources as he may deem advisable.[1]

Approval of Application to Convert. Instructions.

When the application to convert has received the comptroller's approval, a meeting of the shareholders of the state bank should be called, the notice of the meeting required by the laws of the state or the articles of association or incorporation having been given. At this meeting a resolution should be adopted by a vote representing not less than 51 per cent of the capital stock of the bank authorizing the board of directors to change and convert the bank into a national banking association; also authorizing the directors, or a majority thereof, to make and execute the articles of association and organization certificate, and all other papers and certificates, and to do all acts necessary to conversion of the bank into a national banking association.

If it is desired, or is necessary, to increase the capital stock of the state bank, or change the par value of the shares before conversion, the increase or change must be legally effected under the laws of the state, and a certificate from the proper state official obtained showing the increase in capital stock to have been

legally effected prior to the date on which the resolution authorizing conversion is adopted by the shareholders.

The minimum number of directors by which the affairs of a national bank can be lawfully managed is five and, if the state bank has less than that number, an increase should be effected under the laws of the state prior to the execution of any conversion papers other than the application.[1]

Articles of Association.

The shareholders of a state bank having authorized its conversion into a national banking association, the directors should execute the articles of association and organization certificate.[1]

Before receipt of a national bank charter from the comptroller, the president or cashier of the state bank has to swear to the amount of its paid-in and unimpaired capital.

Directors and Officers.—Duly qualified directors of a state bank being converted into a national bank may continue as directors, regardless of the number of shares owned, until the first annual election is held when, to be eligible for re-election, they must own the number of shares required by the National Bank Act. The oaths should be taken as directors of the national bank. Unless officers are reappointed by the directors of the national bank subsequent to their qualification, the form requiring the signatures of the officers of the national bank should show date of appointment by the directors of the state bank and the following explanatory clause should be added: "Appointed at a meeting of the directors of the state bank."

Stock in Federal Reserve Bank.—When a state bank is converted into a national bank, it may continue to hold its stock in the Federal Reserve bank, if it was a member of the system. If, in the conversion, it is increasing its capital and surplus, it must file an application for the additional stock made necessary by the increase. The old certificate of stock in the name of the state bank should be surrendered and canceled, and a new certificate in the new name will be issued.

If the state bank was not a member of the Federal Reserve System, it must make an application for stock, and pay for it, in the same manner as in the case of original incorporation of a national bank.

Certificate Authorizing Commencement of Business.

When all conversion papers have been filed and the comptroller is satisfied that the association has complied with all requirements of law, and that all conditions imposed, if any, have been corrected, he will issue a certificate

[1] *Ibid.*

authorizing conversion of the state bank and commencement of business as a national bank. This certificate must be published in a local or county newspaper for a period of 60 days, and proof of publication sent to the comptroller at the proper time.[1]

Incorporation of State Banks.—The methods of incorporation of state banks and trust companies follow in principle the methods described for the incorporation of national banks. All states, today, have either banking or general corporation laws permitting the incorporation of state banks and trust companies. Application is made by the legally requisite number of incorporators to the proper state authorities for a charter. Most states require publication of the application and an examination as a prerequisite to granting the charter. Space does not permit a complete analysis of every state law. A digest of the essential requirements of each state for bank organization appears in the Appendix.

Reference

Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks (1926), Chaps. I, II, and VII.

[1] *Ibid.*

CHAPTER III

STOCKHOLDERS

Any person, male or female, other than a minor, or any corporation, in general, may be a stockholder of either national or state banks. The right of a woman to hold stock in her own name, and vote it, is dependent upon the law of the state in which the bank is located, and in which the subscription contract is made. Most states, however, by legislation, have granted to women full power to own and control property in their own names, and therefore, by implication, given them full rights in respect to subscribing for and purchasing, holding, and voting bank stock. Stock may be issued in the name of husband and wife with the right of survivorship. This would confer on the survivor the right to sell, assign, or transfer the certificate. Whether such stock or any part thereof would be subject to inheritance taxes would depend upon the law of the state in which the owners resided.

Minors may own stock, but the contract to purchase and the right to vote is lodged in their guardians. A subscription contract of a minor in his own name is voidable, and for that reason would not be accepted by the corporation if it had knowledge of the minority.

There is an important distinction to be drawn between the initial subscribing stockholder at the time of the organization of a banking institution and stockholders who acquire their rights either by purchase or inheritance subsequent to the incorporation of the bank. As has been previously stated, the incorporators of a national bank must be natural persons, thus excluding corporations, but once the bank is organized, artificial persons—for example, corporations—may purchase and own stock. The right of a corporation to own bank stock is dependent not upon the laws relating to the bank whose stock it may own, but upon the state laws, charter, and by-laws controlling the rights of the purchasing corporation. Thus, corporations may own national-bank stock, but national banks, with certain exceptions, may not own stock in other banks or other corporations. This principle applies generally to the incorporation of state banks as well as of national banks.

When the Relation of Shareholder Arises.—To constitute a stockholder there must ordinarily be a definite allotment of the stock, and

notice to the subscriber of the allotment. The issuance of the stock, coupled with delivery and acceptance, and the entry of the name of the owner on the stock books of the corporation is conclusive proof of ownership. A subscription to the stock of a national bank, the payment in full of the subscription, and the entry of the subscriber's name on the books as a stockholder constitutes the subscriber a stockholder, although the certificate is not issued or taken out. The issuance of a certificate is important evidence of the existence of the relationship, but is not necessary, particularly if the stockholder has been enjoying the rights, privileges, and emoluments of a shareholder with the consent of the corporation.

In the case of the organization of a bank, the mutual subscriptions to stock of the organizers are consideration for the subscriptions of all. Such a stock subscription is interpreted as an offer to purchase stock, and becomes automatically accepted by the corporation when the corporation comes into existence. As the offer cannot be accepted by a corporation which is not in being, the subscribers may withdraw their subscriptions, upon proper notice, at any time prior to the incorporation of the bank. The right to purchase is a personal one, and the liability to pay, therefore, is a personal liability. If a subscriber dies before the incorporation of the bank, his estate cannot be held liable to pay for the subscription.

Rights of Stockholders. *a. Dividends.*—Stockholders have the right to receive dividends properly declared and made payable by the action of the board of directors. When the dividend on stock has been declared, it belongs to the existing stockholders, and does not pass with a subsequent transfer of the stock unless by express contract. This rule applies where no specific date has been set by the board of directors as determining the status of the stockholders in relation to that dividend. The board of directors may declare a dividend payable to stockholders of record as of a given date. In that case, all transfers of stock prior to that date carry with them the right to receive the dividend; transfers made after that date do not. If no specific date is set, the dividend is payable to stockholders of record as of the date when the dividend was declared, and not as of the date when the dividend is actually paid.

Dividends are payable, theoretically, upon demand, and no stockholder can start suit against a bank for the collection of dividends declared but not paid until proper demand for the payment of the dividend has been made and refused.

b. Notice of Time and Place of Meeting.—Stockholders have the

right to be notified of the time and place of stockholders' meetings so that they may attend either in person or by proxy. The by-laws or the articles of association ordinarily specify the time and manner in which notice shall be given.

There is nothing in the national bank act regarding notice of the annual meeting of the shareholders of national banking associations when held at the time specified in the articles of associations. If the articles of association and by-laws are silent, the usual notice of the meeting should be given, shareholders being entitled, no doubt, to advice of the meeting notwithstanding the fact that the time is fixed by the articles.[1]

For an annual meeting, at which business of an unusual or extraordinary character, such as the amendment of the articles of association, is to be considered, and for all special meetings of shareholders, notice should be given as required by the articles of association of the bank. Unless provision is made therein, 30 days' notice of meeting, and business to be transacted, should be given. If, for any cause, the election of directors is not made at the time appointed, and the annual meeting is not regularly adjourned, an election must be held on a subsequent day designated by the directors, 30 days' notice of meeting to be given in a newspaper published in the city, town, or county in which the association is located, and if no newspaper is published in such city, town or county, such notice shall be published in newspaper published nearest thereto (Sec. 5149, United States Revised Statutes).

c. Voting by Proxy.—"In all elections of directors, and in deciding all questions at meetings of shareholders, each shareholder shall be entitled to one vote on each share of stock held by him."[2] An executor has the right to vote with respect to the stock standing on the corporate books in the name of the testator on exhibiting an exemplified copy of his letters testamentary. It has been held that a trustee in bankruptcy has the right to vote the stock held in the name of the bankrupt.

Shareholders may vote by proxy, duly authorized in writing. Under Sec. 5144, U. S. Revised Statutes, no officer, clerk, teller, or bookkeeper of a national banking association can act as proxy and no shareholder whose liability on his subscription for stock is past due and unpaid shall be allowed to vote. The comptroller has ruled that a director is an officer, and therefore cannot act as a proxy. A stockholder of a national bank may act as proxy to vote the stock of another stockholder, if properly authorized to do so in writing.

[1] Instructions of the Comptroller Relative to the Organization and Powers of National Banks (1926).

A proxy, however, while it must be in writing, need not be in any particular form, nor need it be acknowledged or proved, but it must be in such shape as reasonably to satisfy the inspectors of elections as to its genuineness, and validity; and to this end the corporate officers may insist upon reasonable evidence of the regularity and genuineness of the proxy before allowing it to be voted. The proxy should be dated.[1]

If more than one proxy has been issued by one shareholder representing his shares of stock, the last-issued proxy is valid and should vote.

A stockholder who signs a form of proxy in blank and hands it over to another to be used in the ordinary way impliedly authorizes that other to fill up the blank with his own name.[1]

The party using the proxy may also fill in blanks as to the hour and day of the meeting. A proxy cannot vote when the owner of the stock is present and votes. A proxy is always revocable, whether made by its terms irrevocable or not.

At a regular meeting of stockholders of a national or a state bank, a majority of votes in person or by proxy present at the meeting is sufficient to elect the board of directors or transact other business, though such votes are a minority of all the stock, unless a different provision is made in the statutes, or by-laws. Certain actions of the stockholders require, by law, the affirmative vote of a given proportion of the total outstanding stock. In the absence of such a special legal provision, however, a quorum to transact ordinary business may consist of any proportion of the stock which the by-laws may designate, and a majority vote of that quorum will be sufficient to transact ordinary business.

There is considerable conflict of opinion on the question of the right of stockholders of banks to place their stock in the hands of trustees for the purpose of voting; in other words, to create a voting trust. The weight of opinion in respect to national banks seems to be that such a voting trust is contrary to public policy, and void. In respect to state banks, favorable action regarding voting trusts has been taken by a number of state courts. In some states this matter is governed by statute. For example, the New York Stock Corporation law, paragraph 50, provides:

. . . that a stockholder may, by agreement in writing, transfer his stock to any person or persons for the purpose of vesting in him or them the right to vote thereon for a time not exceeding 5 years upon terms and conditions stated, pursuant to which such person or persons shall act; and every other stockholder,

[1] *Ibid.*

upon his request therefor, may, by a like agreement in writing also transfer his stock to the same person or persons and thereupon may participate in the terms, conditions, and privileges of such agreement; the certificates of stock so transferred shall be surrendered and canceled and certificates therefor issued to such transferee or transferees in which it shall appear that they are issued pursuant to such agreement and in the entry of such transferee or transferees as owners of such stock in the proper books of the corporation that fact shall also be noted and thereupon he or they may vote upon the stock so transferred during the time in such agreement specified.

Cumulative voting at meetings of shareholders is not authorized by the National Bank Act. For instance, if a shareholder is the owner of 10 shares of stock and 7 directors are to be elected, he cannot cast 70 votes in favor of any one person as a director, but is at liberty to cast only 10 votes for each of 7 candidates.[1]

On the other hand, cumulative voting is frequently permitted by state law, in respect to banking institutions.

d. Right to Inspect the Books of the Corporation.—Stockholders have the right to inspect the books of the bank at all reasonable times, and for all proper purposes. Such a right is a common law right, and not of statutory origin, although statutes have frequently been enacted setting forth the right.

Where such a right is improperly withheld, the court will, upon proper application, enforce the right by means of a mandamus. In some states the courts will enforce the right of inspection, regardless of the motive of the stockholders. In others, they refuse relief when the motive is improper. One Pennsylvania case holds that the right may be exercised through an agent, attorney, or expert, and that the corporation has no right to dictate as to who the agent or attorney shall be. (*Kuhbach* vs. *Irving Cut Glass Co.*, 220 Pa. 427.) *Hodder* vs. *Geo. Hogg Co.* (223 Pa. 196) holds that the fact that the stockholder is interested in a competing corporation is not enough to cause mandamus to be denied. A number of state courts have held that national banks fall in this respect within the provisions of state statutes, and have granted writs of mandamus to compel national banks, for proper purposes, to exhibit their books to a stockholder.

The right of inspection involves the right to make extracts, so that the information will be usable instead of depending on memory, provided again, that the purpose of inspection is a proper one.

What constitutes a proper purpose is extremely difficult to define. In general, any purpose is proper which affects the welfare and interest

[1] *Ibid.*

of the stockholder and is not intended to bring injury to the bank. For example: to ascertain the value of the stock; to ascertain whether the business affairs of the bank have been conducted according to law; to ascertain whether the bank has extended undue credit to its own officers or its directors, have been held to be proper purposes. The judge, in *Guthrie* vs. *Harkness* (199 U. S. 148), states:

> It does not follow that the courts will compel the inspection of the bank's books under all circumstances. In issuing the writ of mandamus the court will exercise a sound discretion and grant the right under proper safeguards to protect the interests of all concerned. The writ should not be granted for speculative purposes, or to gratify idle curiosity, or to aid a blackmailer, but it may not be denied to the stockholder who seeks the information for legitimate purposes.

A proper place for the examination is at the bank, itself, where the books are kept; and a proper time would undoubtedly be at the close of banking hours, when a minimum of interference with the daily work of the bank would result.

e. Right to Authorize Assessment to Restore Impaired Capital Stock.

(1) National Banks.

> If an examination of a national bank discloses losses exceeding the amount of surplus and undivided profits and thus shows an impairment of capital, the bank is written and advised that the losses should be charged off without delay, the formal notice of impairment of capital being enclosed with instructions to make the deficiency good by assessment of the stock or to place the association in voluntary liquidation as required by law.
>
> If the directors or shareholders will unconditionally purchase for cash sufficient of the worthless assets to restore the capital, the formal notice of impairment will be withdrawn.
>
> As Sec. 5205, United States Revised Statutes, requires an assessment of the stock to make good an impairment of capital to be collected within three months from the date of the receipt of the comptroller's notice of such impairment, the directors should give each and every shareholder of the association immediate notice of a meeting to be held in 30 days for the purpose of voting on the question of the payment of the assessment or the placing of the association in liquidation, in order that they may be in a position at the end of 3 months from the date of the receipt of this notice, to advertise as provided by Sec. 4 of the Act of June 30, 1876, the sale of the stock of any delinquent shareholder to make good his proportion of the assessment.
>
> At the shareholders' meeting, no director, other officer, or employee can act as proxy and vote the stock of another stockholder. . . .
>
> If the shareholders at the meeting vote an assessment upon the stock for the

purpose of restoring said impaired capital a report of the resolution should be sent to the comptroller. . . .

Section 5205, United States Revised Statutes, provides that if any shareholder or shareholders of such bank shall neglect or refuse, after 3 months' notice, to pay the assessment, as provided in that section, it shall be the duty of the board of directors to cause a sufficient amount of the capital stock of such shareholder or shareholders to be sold at public auction (after 30 days' notice shall be given by posting such notice of sale in the office of the bank, and by publishing such notice in a newspaper of the city or town in which the bank is located, or in a newspaper published nearest thereto), to make good the deficiency, and the balance, if any, shall be returned to such delinquent shareholder or shareholders.[1]

(2) State Banks.—The banking laws of the various states follow in a general way the provisions of the National Banking law, set forth above.

f. Right to Surplus upon Liquidation of the Bank.—A stockholder is entitled to the surplus accumulated by the bank whenever it is liquidated. Any surplus which may remain after the payment of all corporate debts in the hands of the assignee, trustee, receiver, or other person who has had the corporate property committed to his charge for the purpose of winding up its affairs belongs to the shareholders. They are entitled to have it apportioned among them according to the number of their respective shares. This right may be enforced by a bill in equity brought against the trustee or other official winding up the affairs of the bank, demanding that he account for, collect, and distribute the surplus property.

g. Right to Increase Capital Stock. 1. National Banks.—The following statutory provision governs the right to increase National Bank stock:

Any national banking association may, with the approval of the Comptroller of the Currency, and by a vote of shareholders owning two-thirds of the stock of such associations, increase its capital stock to any sum approved by the said comptroller, but no increase in capital shall be valid until the whole amount of such increase is paid in and notice thereof, duly acknowledged before a notary public by the president, vice-president, or cashier of said association, has been transmitted to the Comptroller of the Currency and his certificate obtained specifying the amount of such increase in capital stock and his approval thereof, and that it has been duly paid in as part of the capital of such association: *Provided*, however, that a national banking association may, with the approval of the Comptroller of the Currency, and by the vote of shareholders owning two-thirds of the stock of such association, increase its capital stock by the

[1] *Ibid.*

declaration of a stock dividend, provided that the surplus of said association, after the approval of the increase, shall be at least equal to 20 per cent of the capital stock as increased. Such increase shall not be effective until a certificate certifying to such declaration of dividend, signed by the president, vice-president, or cashier of said association and duly acknowledged before a notary public, shall have been forwarded to the Comptroller of the Currency and his certificate obtained specifying the amount of such increase of capital stock by stock dividend, and his approval thereof.[1]

When the comptroller has advised the bank that the proposition to increase meets with his approval, a meeting of the shareholders should be called after giving the notice required by the articles of association of the national bank, this period being usually 30 days. This notice must state specifically the business to come before the meeting. Shareholders who are unable to be present at the meeting may be represented by proxy for which purpose a special form of proxy is used stating the business to come before the meeting.

A portion of a proposed increase will not be approved. The whole amount as stated in the resolution adopted by the vote of the shareholders must be paid in and the payment certified to the comptroller. The increase becomes valid upon the issuance of the Comptroller's Certificate of Approval, prior to which no change should be made in the capital stock account, nor certificates of stock issued. If any assets of another bank are to be taken over in connection with the increase, an examination to determine their character and value will be required; and no assets may be purchased that are not in conformity with the law and of satisfactory value. A contract should be entered into between the two banks covering purchase of assets and assumption of liabilities and a copy should be filed with the comptroller.[2]

h. Rights of Shareholders in Connection with Increase of Capital.

While there is no provision in the National Bank Act covering this question, under the common law, when the capital stock of a corporation is increased by the issuance of new stock, every stockholder of the original stock has the right to offer to subscribe for and to demand from the corporation such a proportion of the new stock as the number of shares already owned by him bears to the whole number of shares before the increase.[3]

There is no requirement in the National Bank Act fixing the length of notice which stockholders should be given to subscribe for their proportion of stock in connection with an increase in the capital of the bank, but the rules of the New York Stock Exchange, requiring a

[1] McFadden bill, Sec. 5, Amending Sec. 5142, Revised Statutes of the United States.

[2] Instructions of the Comptroller relative to the Organization and Powers of National Banks (1926).

[3] *Ibid.*

minimum of 25 days' notice to shareholders, 10 days' notice of the issuance of the warrants and 15 days thereafter to make subscriptions would probably be held sufficient notice by the courts. At the end of that time, failure to subscribe would cancel the outstanding right.

If the stock of a national bank is worth more than par, and the new issue is being sold at par, the issuance of new stock naturally will depreciate the book value of all the stock of the bank. The shareholder who does not desire to subscribe to the new stock, but wishes to protect his equity in the assets of the bank should be given a warrant indicating the right to subscribe and be permitted to assign this warrant to other parties for such consideration as he may be able to obtain.[1]

Right to Subscribe at Par.—A very interesting legal question arises when a stockholder demands the right to purchase his proportion of the increase at par when the stock is being offered by the resolution of the directors and shareholders at a price in excess of par. The general rule applicable to both national and state banks seems to be that a stockholder has the right to subscribe to the new stock at par, irrespective of the price placed upon the stock, unless he attended the meeting of the shareholders either in person or in proxy and authorized by his vote the price as fixed, in which case he would be estopped from exercising his ordinary common law right to subscribe at par. New York apparently does not follow this general rule.

The following is the text of an opinion by Thomas B. Paton, Assistant General Counsel of the American Bankers' Association:

In the increase of the capital stock of a national bank, where the shareholders by a two-thirds vote, vote to increase the capital and in the resolution authorizing the increase, fix a price at which the new stock shall be sold, can a shareholder demand his share of the new stock at par, or at a price less than the price fixed in the resolution?

Opinion: If the shareholder participated in the meeting and voted for the resolution increasing the capital stock and fixing a price above par at which the stock should be sold, I believe he would be bound by such action and would be estopped from claiming his otherwise legal right to participate in the purchase of his proportionate share of the new stock at par.

But in the case of a shareholder who did not participate in the meeting and vote for the increase, I think he would be entitled to demand his share of the new stock at par, although less than the price fixed in the resolution, unless, of course, such right was curtailed by some provision in the charter or articles of association of the bank. This conclusion is reached from an examination of the authorities involving the rights of shareholders in domestic corporations

[1] *Ibid.*

in such cases, some banking and some industrial, but none so far as found have involved the rights of shareholders of national banks in case of increase of their capital stock. But, by analogy, the same rule should apply to shareholders in national banks as to shareholders in other corporations.

I would cite the following authorities as bearing on the subject in support of the conclusion reached. I do not refer to the provisions of the National Bank Act relative to increase of capital stock as I presume you are familiar with such provisions.

Cook, in his work on "Corporations" (1 Cook on Corporations, 4th Ed., Sec. 286), lays down this rule: "When the capital stock of a corporation is increased by the issue of new shares, each holder of the original stock has a right to offer to subscribe for and to demand from the corporation such a proportion of the new stock as the number of shares already owned by him bears to the whole number of shares before the increase. The preemptive right of the shareholders in this respect to new stock is well recognized. *Gray* vs. *Portland Bank*, 3 Mass. 364; *Miller* vs. *Ill. Cent. R. Co.*, 24 Barb. (N. Y.) 312; *Wilson* vs. *Bank*, 29 Pa. St. 537; *Mason* vs. *Davol Mills*, 132 Mass. 76. . . . The corporation cannot compel the old stockholders upon their subscription for new stock to pay more than par value therefor. They are entitled to it without extra burden or price beyond the regular par value. An attempt to deprive the stockholder of this right will be enjoined in the absence of laches or acquiescence. The courts go very far in protecting the right of stockholders to subscribe for new stock. It is often a very important right." Cunningham's Appeal, 108 Pa. St. 546, holding that an insurance company in increasing its capital stock must do so either by pro rata allotment at par to its stockholders or by independent and voluntary subscription as in the formation of a new company; that the stockholders cannot be charged a bonus on the stock to which they are entitled to subscribe. *De La Cuesta* vs. *Ins. Co.*, 146 Pa. St. 62, 9 L.R.A. 631 and note; *Jones* vs. *Concord, etc.*, *R. Co.*, 67 N.H. 234, 30 Atl. 614.

The general rule has been that where there is a statute permitting corporations to increase their capital stock by increasing the number of their shares, which shares are to be allotted pro rata to the shareholders according to their respective interests, it is not competent for the corporation to charge a bonus to the shareholders who receive the new shares in distribution, and equity should enjoin the company from refusing to allow a shareholder to receive his allotment at par without paying a bonus. 14 C.J. 396. The rule is similarly stated in 26 Am. and Eng. Encycl. Law, p. 948, and citing among other authorities, *Hammond* vs. *Edison Illuminating Co.* 131 Mich. 79 (1902), 90 N.W. 1040, wherein it was held that a stockholder of a manufacturing corporation is entitled to purchase at par value his pro rata share of additional stock, increased pursuant to statute and his right cannot be restricted by a vote of other stockholders owning two-thirds of the stock, though at a regularly called meeting, requiring the payment of a premium therefor. See also *Bennett* vs. *Baum*, 90 Nebr. 320, 133 N.W. 439; *Strickler* vs. *McElroy*, 45 Pa. Super. Ct. 165.

The Court of Appeals in New York refused to uphold the right of a stock-

holder to subscribe for his proportion of the increased stock at par value where an outsider had offered a premium, which the majority voted to accept. *Stokes vs. Continental Trust Co.*, 78 N.E. 1090, 186 N.Y. (1906) 285, 12 L.R.A. (N.S.) 969 and note (1913).[1]

i. Stock Dividends.—The capital stock of a bank may be increased by the issuance of stock dividends payable out of accumulated surplus. Until the passage of the McFadden bill the specific right to issue stock dividends was not granted to national banks by any statutory provision. *Up to 1920, the various Comptrollers of the Currency had* discouraged the practice of the declaration of stock dividends by national banks, and it had been accomplished by declaring cash dividends simultaneous to the declaration of an increase in stock and by permitting the stockholders to utilize the cash dividends to subscribe to the new stock issue. After 1920, the Comptroller of the Currency permitted the direct payment of stock dividends, provided that the comptroller's permission to increase stock had been obtained; and provided that the withdrawal from the accumulated surplus would not reduce that surplus to an amount less than 20 per cent of the combined total of the old and new stock. The McFadden bill settled all controversy in the matter by specifically authorizing the payment of stock dividends by national banks.

j. Right to Reduce Capital Stock.

A national banking association may, with the consent of the Comptroller of the Currency and of the Federal Reserve Board, and by a vote of shareholders owning not less than two-thirds of the shares, reduce its capital stock to any sum not below the minimum amount required by the National Bank Act.[2]

The comptroller's consent will be predicated upon an examination of the condition of the bank and upon a recommendation of the Federal Reserve Board. A special meeting of the stockholders is necessary with the notice of the date and object of such meeting in conformity with the articles of association of the bank, unless said notice is unanimously waived. After the resolution has been adopted by the shareholders, the reduction becomes operative upon the issuance of the comptroller's certificate of approval. Each shareholder has the right to participate in the reduction in proportion to the number of shares held and receive cash for the stock surrendered, unless the whole or a por-

[1] Paton's Digest, Vol. 2, p. 1289.

[2] Instructions of the Comptroller relative to the Organization and Powers of National Banks (1926).

tion of the amount is to be used to charge off losses. If only a portion is to be so used, the balance may be distributed among the shareholders of record, or, if authorized by resolution of the shareholders, it may be carried to the surplus or profit accounts of the bank. The use of the proceeds resulting from the reduction should be determined by resolution adopted by majority vote authorizing the disposal of the assets resulting therefrom.[1]

(1) *Righ tto Sue Directors for Malfeasance in Office.*—Shareholders have a common-law right which is occasionally supplemented by statutory provision to sue directors for malfeasance in office when loss has resulted therefrom to the shareholders. Such malfeasance in office must go beyond simple errors in judgment which are not penalized. To constitute malfeasance the errors must be so gross as to resemble fraud; and must show entire incapacity and unfitness for office, or the acts of the directors must constitute some breach of statutory or charter provisions.

The liability of directors in this respect is a personal one, payable out of their personal property, and cannot be charged against the assets of the bank itself. Suit cannot be brought against the corporation nor can corporate funds be used to satisfy it. If the malfeasance of the directors has resulted in failure of the bank, suit against them may be brought by the receiver or trustee, or other officer winding up the bank's affairs; but the stockholders have a right to bring suit irrespective of the action of a receiver or trustee; that is, if the receiver or trustee fails or refuses to take such a step.

Liabilities of Stockholders. *a. Double Liability on Stock.* (1) National Banks.—Section 23 of the Act of Dec. 23, 1913 (38 Statute Laws 273) provides as follows:

Section 23.—The stockholders of every national banking association shall be held individually responsible for all contracts, debts, and engagements of such association, each to the amount of his stock therein, at the par value thereof in addition to the amount invested in such stock. The stockholders in any national banking association who shall have transferred their shares or registered the transfer thereof within 60 days next before the date of the failure of such association to meet its obligations, or with knowledge of such impending failure, shall be liable to the same extent as if they had made no such transfer, to the extent that the subsequent transferee fails to meet such liability; but this provision shall not be construed to affect in any way any recourse which such shareholders might otherwise have against those in whose names such shares are registered at the time of such failure.

[1] *Ibid.*

The purport of this statute is that in the event of insolvency of a national bank the shareholders shall be liable to the creditors in an amount not in excess of the par value of the stock they hold. To illustrate:

Mr. Jones is a stockholder in a national bank owning 20 shares of par value of $100 each. The national bank has a total capitalization of $400,000 divided into 4,000 shares of par value of $100 each. The bank fails. Its assets are liquidated and expended for the payment of of its debts. After they have been entirely utilized, there are still debts outstanding in the amount of $100,000. The creditors representing this $100,000 claim have the right to proceed either in their own names, or represented by the receiver or other official winding up the affairs of the bank, against the stockholders, and Mr. Jones' liability would be represented by the proportion that his stock bears to the total stock outstanding; in other words, 20/4000, of $100,000, or $500. Had the unpaid debts of the bank exceeded $400,000, the maximum liability of Mr. Jones would be represented by an amount equal to the par value of his stock, or $2,000. Mr. Jones is liable only for his proportion of the indebtedness and his liability cannot be increased by the insolvency of other stockholders rendering it impossible to collect from them their share of the obligation.

Stockholders' Defense.—Stockholders may defend a claim made against them seeking to enforce their double liability on the ground that the directors, in creating the obligations which are sought to be enforced, exceeded their statutory powers with the knowledge of the creditors who are seeking to enforce their claims. Creditors, however, who were innocent, that is to say, had no knowledge that their claims resulted from unlawful acts of the directors, would be permitted to recover.

(2) State Banks.—The double liability of stockholders in state banks is determined by the statutory law of the particular state in question.

The matter in Pennsylvania is somewhat unsettled, as is indicated by the following opinion of Mr. Paton:

By Pennsylvania (Stat. (1920) Sec. 1439) the legislature imposed a liability on all stockholders in banks, banking companies, savings fund institutions, trust companies and all other incorporated companies doing the business of banks for all debts and deposits to double the amount of capital and stock held and owned by each. There was a proviso that, in case of banks already chartered, the liability should not accrue until the stockholders should declare at a meeting their intention to be bound by its provisions. Furthermore, the Banking Act of 1876 for the incorporation and regulation of banks of discount and

deposit provides (Pa. Stat. (1920), Sec. 1184) that the shareholders of any corporation formed under this act shall be individually responsible, equally and ratably, but not one for the other, for all contracts, debts and engagements of such company to the amount of their stock therein and the par value thereof in addition to the par value of such shares. However, it has been held in Pennsylvania that trust companies do not have the usual powers of discount and exchange, and therefore their stockholders are not subject to double liability in the absence of the double liability clause in their charter. *De Haven* vs. *Pratt*, 72 Atl. 1068, 223 Pa. (1909) 633. The question of double liability of stockholders of trust companies has not come up since the enactment of Pa. 1923, No. 127, p. 173, which completed the banking powers of trust companies, but it would seem that stockholders of trust companies availing themselves of the usual banking powers will in the future be subject to the same double liability imposed on bank stockholders.[1]

b. Lien on Bank Stocks. (1) National Banks.—A national bank has no lien on its stock for indebtedness of stockholders to the bank, and a national bank cannot acquire such a lien by inserting any provision to that effect in the articles of association or by-laws. As a national bank has no lien, it cannot prevent the transfer of the stock by the debtor to a third person, but a national bank may attach such stock in the hands of the holder when the shares are in the possession of the shareholder at the time of attachment.

(2) State Banks.—The legislatures of different states vary in their policy. Some expressly provide and some prohibit a lien by the issuing bank on its own shares of stock for an indebtedness of the stockholders. For example, such a lien exists in Pennsylvania, New York, Arkansas, Iowa, and Oklahoma. Under the operation of such a lien the bank could refuse to transfer the stock on its books to any third party until all indebtedness due by the transferee to the bank had been satisfied.

Reference

Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks (1926), Chaps. V and VIII.

[1] Paton's Digest, Vol. I, p. 131.

CHAPTER IV

DIRECTORS

Banking institutions, like other corporations, are under the direction and control of a board of directors elected in ways specified by law or by the by-laws of the corporation. Section 5145, United States Revised Statutes, provides:

> The affairs of each association (national bank) shall be managed by no less than five directors who shall be elected by the shareholders at a meeting to be held at any time before the association is authorized by the Comptroller of the Currency to commence the business of banking, and afterwards at meetings to be held on such day in January of each year as is specified in the articles of association. The directors shall hold office for 1 year and until their successors are elected and have qualified.

The Federal law does not provide a maximum number and some national banks have large boards, chiefly resulting from consolidation. Many of the state laws provide for a minimum number of directors, and some of the states also fix a maximum number. The comptroller has ruled that:

> . . . instead of providing in Sec. 3 of the Articles of Association for the election of the first board of directors the names of the directors may be given therein if the stockholders are agreed as to the persons who are to constitute the board. In this event the third article should read as follows:
>
> "The board of directors shall consist of .... shareholders and the following persons (here insert their names) are hereby appointed directors of this association to hold office as such until the regular annual election takes place, pursuant to the fourth article of these articles of association, and until their successors are chosen and have qualified."
>
> This third section may, if desired, provide for what is termed a sliding scale instead of a fixed number of directors; in other words, a minimum and maximum number.[1]

[1] Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks (1926).

It will thus be seen that although the law does not fix a maximum number of directors for a national bank, it is within the power of the stockholders of the bank to provide for a maximum number, either in their organization certificate or in their by-laws.

Legal Qualifications of Directors of National Banks.—Section 17 of the McFadden bill (Act of Feb. 25, 1927) provides:

Every director must during his whole term of service be a citizen of the United States and at least three-fourths of the directors must have resided in the state, territory, or district in which the association is located, or within 50 miles of the location of the office of the association, for at least one year immediately preceding their election, and must be residents of such State or within a 50-mile territory of the location of the association during their continuance in office. Every director must own in his own right shares of the capital stock of the association of which he is a director, the aggregate par value of which shall not be less than $1,000, unless the capital of the bank shall not exceed $25,000, in which case he must own in his own right shares of such capital stock the aggregate par value of which shall not be less than $500. Any director who ceases to be the owner of the required number of shares of the stock, or who becomes in any other manner disqualified shall thereby vacate his place.

The laws of practically all of our states fix the legal qualifications of the directors of state banks. They all limit the directorship to citizens of the United States. Some proportion of the directors must in all cases be citizens of the state in which the bank is located, and they must own some minimum number of shares of stock in the bank in order to qualify.

A woman, whether married or unmarried, possessing the qualifications of directors required by Federal statute may hold directorship in a national bank provided that in case of a married woman the laws of the state do not prohibit or incapacitate her from owning stock.[1]

Election and Oaths of Directors.

After the execution of the organization certificate, if the directors are not designated in the articles of association, the shareholders should proceed to elect directors. Each director must after his election or appointment (but not prior to the date of the acknowledgment of the organization certificate) take an oath of the following form:

[1] Paton's Digest, Vol. I, p. 123.

OATH OF DIRECTOR [1]

State of............. }
County of........... } ss.

I, the undersigned, director of The ...., located at ...., being a citizen of the United States, and resident of the state of ...., do solemnly swear (affirm) that I will, so far as the duty devolves on me, diligently and honestly administer the affairs of said association; and that I will not knowingly violate, or willingly permit to be violated, any of the provisions of the statutes of the United States under which this association has been organized; and that I am the owner in good faith and in my own right, of the number of shares of stock required by said statutes, subscribed by me or standing in my name on the books of the said association; and that the same is not hypothecated or in any way pledged as security for any loan or debt.

____

Subscribed and sworn (affirmed) to before the undersigned this ...... day of ...., 19.....

____

(Official seal of officer) Notary Public

Vacancies in the Board.—Vacancies in the board of directors when caused by death or resignation are filled by appointment by the remaining directors and any director who is appointed shall hold his place until the next election.

Qualifications of Directors Other than Legal.—Directors have two primary functions: first, to acquire new business for the bank, and, second, to direct and control its operations. This latter function is to a considerable extent delegated to the various banking officials. Men are therefore selected as directors for qualifications other than simply banking knowledge or banking experience. Their names may be valuable advertisements for the bank, and therefore men of social and financial prominence in a community will be selected if possible. They will be chosen on account of their financial affiliations with other institutions or their business affiliations with large manufacturing or commercial houses under the expectation that they will influence a flow of business to the bank from the institutions with which they are associated. If the activities of the bank extend over a considerable geographical area, representative business and financial men from different sections of that area will be represented on the board in as far as this is permissible

[1] Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks (1926).

under either state or national laws. Diversification of industry and activity are taken into consideration in the selection of directors. One or more lawyers will generally appear on the board because they may give their legal opinions without delay or remuneration when questions involving matters of law come before the board, and secondly because lawyers have extensive associations with business clients, aid in drawing up wills, trust agreements, and numerous papers and contracts in respect to which the banks may act in various capacities as executor, trustee, etc. Lawyer directors are expected to bring a certain proportion of their clients' business to the bank. Manufacturers, distributors, officials in large public utilities, insurance men, stock brokers, etc. will be represented on the board for the diversified business which their connections will ordinarily bring to the bank. It goes without saying that bank directors should have the qualifications of personal integrity and a reasonable amount of business judgment. To illustrate the principles above enunciated there follows a list of the names and business affiliations of the directors of the Continental National Bank and Trust Company of Chicago, as of February, 1928.

Philip D. Armour........	First Vice-president, Armour & Co.
William W. Atterbury....	President, The Pennsylvania Railroad Co.
Alexander F. Banks......	President, E. J. and E. R.R. Co.
Eugene J. Buffington.....	President, Illinois Steel Co.
Claude G. Burnham......	Executive Vice-president, Chicago, Burlington & Quincy Railroad Co.
H. E. Byram............	Chairman of Board, Chicago, Milwaukee, St. Paul & Pacific Railroad Co.
Clifford D. Caldwell......	President, By-products Coke Corp.
Robert F. Carr..........	President, Dearborn Chemical Co.
Edward F. Carry.........	President, The Pullman Company
William J. Chalmers......	
Alfred Cowles............	President, Rialto Trust
Edward A. Cudahy.......	Chairman of Board, Cudahy Packing Co.
Bernard A. Eckhart......	President, B. A. Eckhart Milling Co.
Louis Eckstein...........	President, The Consolidated Magazines Corporation.
George B. Everitt........	President, Montgomery Ward & Co.
J. Fletcher Farrell........	Vice-president and Treasurer, Sinclair Consolidated Oil Co.
Milton S. Florsheim......	Chairman of Board, The Florsheim Shoe Co.
George F. Getz..........	Chairman of Board, Globe Coal Co.
Charles F. Glore.........	Field, Glore & Co.
William F. Hayes........	W. F. Hayes & Co.
Frank Hibbard..........	Chairman of Board, Spencer, Bartlett & Co.
Edward Hines...........	President, Edward Hines Lumber Co.

William V. Kelley	Chairman of Board, The Miehle Printing Press and Mfg. Co.
D. F. Kelly	President, The Fair
David R. Lewis	Vice-president
Eames MacVeagh	Vice-president, Franklin MacVeagh & Co.
D. R. McLennan	President, Marsh & McLennan, Inc.
Theodore F. Merseles	President, Johns-Manville, Inc.
James A. Patten	Capitalist
Herbert Perkins	Vice-president, International Harvester Co.
William H. Rehm	President, National Beverage Co.
Arthur Reynolds	President
George M. Reynolds	Chairman, Board of Directors
James W. Stevens	Chairman of Board, Illinois Life Insurance Co.
Robert W. Stewart	Chairman of Board, Standard Oil Company of Indiana
W. B. Storey	President, Atchison, Topeka & Santa Fé Railway Co.
Herman Waldeck	Vice-president
Fred E. Weyerhaeuser	Lumber, St. Paul, Minn.
Charles P. Wheeler	President, Pickands Brown and Co.
F. Edson White	President, Armour & Co.
O. T. Wilson	President, Wilson Brothers

Interlocking Directorates.—It has been the policy of the Federal government to prohibit so-called interlocking directorates, that is to say, the services by a single man or group of men on the boards of a number of banks whose location would ordinarily bring them into competition with one another. The purpose of this prohibition was to guard against the concentration of capital and credit control by relatively small groups of men. The fear lying at the back of this prohibition was the creation of a *money trust* resulting in the substantial control of a large proportion of the credit resources of the country and hence of the industrial activities of the country by a small group of individuals. So far as the national system is concerned, interlocking directorates are controlled by Sec. 8, as amended, of the Clayton Antitrust law of Oct. 15, 1914, which reads as follows:

That from and after 2 years from the date of the approval of this act no person shall at the same time be a director or other officer or employee of more than one bank, banking association or trust company organized or operating under the laws of the United States either of which has deposits, capital, surplus, and undivided profits aggregating more than $5,000,000; and no private banker or person who is a director in any bank or trust company organized and operating under the laws of a state, having deposits, capital, surplus, and undivided profits aggregating more than $5,000,000 shall be eligible to be a director in

any bank or banking association organized or operating under the laws of the United States. The eligibility of a director, officer, or employee under the foregoing provisions shall be determined by the average amount of deposits, capital, surplus and undivided profits as shown in the official statements of such bank, banking association or trust company filed as provided by law during the fiscal year preceding the date set for the annual election of directors and when a director, officer or employee has been elected or selected in accordance with the provisions of this act it shall be lawful for him to continue as such for one year thereafter under said election or employment.

No bank, banking association, or trust company organized or operating under the laws of the United States, in any city or incorporated town or village of more than 200,000 inhabitants, as shown by the last preceding decennial census of the United States, shall have as a director or other officer or employee any private banker or any director or other officer or employee of any other bank, banking association, or trust company located in the same place: *Provided*, That nothing in this section shall apply to mutual savings banks not having a capital stock represented by shares: *Provided further*, That a director or other officer or employee of such bank, banking association, or trust company may be a director or other officer or employee of not more than one other bank or trust company organized under the laws of the United States or any state where the entire capital stock of one is owned by stockholders in the other: *And provided further*, That nothing contained in this section shall forbid a director of Class A of a Federal Reserve bank, as defined in the Federal Reserve Act, from being an officer or director, or both an officer and director, in one member bank: *And provided further*, That nothing in this act shall prohibit any private banker or any officer, director, or employee of any member bank or Class A director of a Federal Reserve bank, who shall first procure the consent of the Federal Reserve Board, which board is hereby authorized, at its discretion, to grant, withhold, or revoke such consent, from being an officer, director, or employee of not more than two other banks, banking associations, or trust companies, whether organized under the laws of the United States or any state, if such other bank, banking association, or trust company, is not in substantial competition with such member bank.

The consent of the Federal Reserve Board may be procured before the person applying therefor has been elected as a Class A director of a Federal Reserve bank or as a director of any member bank. . . .

When any person elected or chosen as a director or officer or selected as an employee of any bank or other corporation subject to the provisions of this act is eligible at the time of his election or selection to act for such bank or other corporation in such capacity, his eligibility to act in such capacity shall not be affected, and he shall not become or be deemed amenable to any of the provisions thereof by reason of any change in the affairs of such bank or other corporation from whatsoever cause, whether specifically excepted by any of the provisions hereof or not, until the expiration of 1 year from the date of his election or employment.

Interlocking Directorates in Respect to Banks Engaged in Foreign Banking.—Under the Act of Sept. 7, 1916:

> . . . any director or other officer, agent, or employee of any member bank may, with the approval of the Federal Reserve Board, be a director or other officer, agent, or employee of any bank or corporation chartered or incorporated under the laws of the United States or of any state thereof and principally engaged in international or foreign banking or banking in a dependency or insular possession of the United States either directly or through the agency, ownership, or control of local institutions in foreign countries or in such dependencies or insular possessions in the capital stock of which such member bank shall have invested without being subject to the provisions of Sec. 8 of the Clayton Act.

The state laws as a rule do not contain any provisions whatever in respect to interlocking directorates of state institutions. There may, then, be interlocking directorates among the state institutions. These interlocking directors come under the terms of the Federal statute only when it is proposed to elect one or more of them as members of the boards of national banks. Their election to the board of a national bank may be prevented, but their services as directors of state institutions cannot be prevented by reason of their holding directorships in national banks. In such a case the re-election of the director of the national bank may be prohibited.

The public fear of a money trust seems to be largely dissipated today, and there is little evidence of any attitude to impose serious restrictions upon the growth of interlocking directorates within the terms of the existing laws. More important than interlocking directorates between banking institutions is the growing practice of interlocking directorates between banks and large business houses. There is a growing tendency for large banking houses to be represented on the boards of railroads, industrial corporations, or investment trusts with whom they have business connections or for whom they carry out extensive financing activities.

Directors' Compensation.—Directors who are not also officers of the bank are ordinarily compensated by means of a fee paid for attendance at directors' meetings. This fee may range anywhere from $2.50 up to $20 or more. The fee is ordinarily payable only when the directors attend the meetings. In some instances the fees of the absent directors are divided among the directors present.

There has been considerable controversy in some circles as to the advisability of paying directors an amount sufficient to compensate them for their directing services. Ordinarily, the fee paid for attend-

ance at meetings does not represent such a compensation, and nothing exists in either Federal or state law to prohibit the payment to directors of salaries adequate to compensate them for the services rendered. Those in favor of paying to the directors an adequate compensation argue first that such payment is just, and secondly, that it would tend to induce the directors to give to the affairs of the bank a larger degree of care and attention than is likely to be rendered for the inadequate payment represented by directors' fees. On the other hand, it has been argued that directors should serve partially as a public duty; that their position as directors gives them a prestige in the community, and their banking affiliations will tend to give them certain business advantages, chiefly in the financial accommodation extended by the bank to the business firms with which they are associated. It is further argued that if the salary or compensation becomes large enough to be an object of consideration in itself, it may have the tendency to attract less desirable men to try to secure election to the board simply for the sake of the salary attached to the position. It is felt in many circles that the position of director of a bank should not be made the subject of economic competition.

Term of Office.—In the national system, directors are elected for the term of 1 year and until their successors are elected and qualified. The term of office of directors of state banks and trust companies is determined either by the laws of the state or, in the absence of such legal provisions, by the by-laws of the corporation.

Directors' Meetings.—The directors meet as frequently as they may decide, but as a rule not less often than once a month. The number of meetings depends upon the amount of work to be done. In smaller banks or banks located in small communities, monthly meetings are frequently found to be adequate. In the larger city banks the directors meet more frequently, and committees of the board are appointed to meet with even greater frequency to exercise the functions of the entire board in the intervals between their meetings. For example, a loan committee or an executive or finance committee may meet daily or at any other interval in order to pass upon applications for loans which may exceed in size amounts which executive officers are authorized to extend on their own initiative, and which cannot well be held over until the regular meeting of the board. These loans are then reported to the board at its regular meeting and any further action which may be necessary in respect to them is taken at the same time. A careful record should be kept of the matters acted upon at every meeting of the directors. For the purpose of keeping such a record the

directors name a secretary. In the national system the cashier of the bank is ordinarily secretary of the board. In the state banking systems the secretary of the board may be either the cashier or a special officer called the secretary of the bank who may combine with his duties as secretary of the board some other activity as, for example, treasurer or vice-president. Meetings of directors are presided over generally by the president of the bank, but in a number of large institutions today a special office known as chairman of the board of directors has been created.

The purpose of the creation of a chairman of the board is either to honor an officer who desires to withdraw from active management of the bank, but whose name is valuable to the bank, and who may wish to still interest himself in the bank's affairs, or to take care of the president of an amalgamating institution. When two or more banks consolidate, it is frequently necessary to create offices for the higher officials of the consolidating institutions. Each of the institutions had a president and these officers may object to becoming vice-presidents of the consolidation. It is quite customary to make one of them president of the new institution, another chairman of the board, and where a number of banks are consolidating, another president may be chairman of the finance committee or take some analogous chairmanship which will allow him to retain his prestige.

Powers of Directors.—The administration of the bank devolves upon the board of directors. They are responsible to the stockholders for the success of the bank, and all matters of policy originate in or are decided by the board. The directors appoint the president, vice-presidents, the cashier, and other officers, determine their salaries, define their duties (subject to the law), require bonds of them and fix the amount and penalty thereof, dismiss such appointees at their pleasure and appoint others in their place. In theory the directors have power to appoint every clerk, stenographer, bookkeeper, and other employee of the bank, but in practice they customarily delegate this duty to one or more of the officers of the bank.

The directors have the power to name as many committees from their members as they may desire, and to delegate to these committees certain specific functions, as for example, a loan committee to pass upon loans and discounts.

The directors have the power to prescribe and amend the by-laws not inconsistent with law, regulating, for example, the mode, time and place of election of directors, the order, method and conduct of general business at directors' meetings, the manner of transfer of stock, etc.

They determine the propriety and amount of loans and investments; alterations, enlargements or changes in the bank's quarters; the initiation of proposals for the increase or reduction of the bank's capital stock; and the opening of branches and consolidation with other institutions—although some of these matters must receive the assent of the stockholders before they can be accomplished. They may and should require reports from the officials of the bank as to the conduct of their departments and examine into the affairs of the bank at their pleasure, and in general exercise full executive authority and control. They have the power to declare dividends and to determine what proportion of the profits shall be so paid, what proportion shall be carried to surplus and what proportion shall be kept in undivided profits account, subject to the provisions of the national or state banking laws, as the case may be.

Section 5199, United States Revised Statutes, provides as follows:

The directors of any association (national) may, semiannually, declare a dividend of so much of the net profits of the association as they shall judge expedient; but each association shall before the declaration of the dividend, carry one-tenth part of its net profits of the preceding half-year to its surplus fund until the same shall amount to 20 per cent of its capital stock.

Section 5204, United States Revised Statutes, provides:

No association, or any member thereof, shall, during the time it shall continue its banking operations, withdraw, or permit to be withdrawn, either in the form of dividends or otherwise, any portion of its capital. If losses have at any time been sustained by any such association, equal to or exceeding its undivided profits then at hand, no dividend shall be made; and no dividend shall ever be made by any association, while it continues its banking operations, to an amount greater than its net profits then on hand, deducting therefrom its losses and bad debts. All debts due to any association, on which interest is past due and unpaid for a period of 6 months, unless the same are well secured, and in process of collection, shall be considered bad debts within the meaning of this section. But nothing in this section shall prevent the reduction of the capital stock of the association under Sec. 5143.

After the surplus of the bank has reached 20 per cent of its capital, the directors may declare any proportion of the net earnings as a dividend. It is ordinarily the policy of banks to declare only a fraction of their earnings as dividends, and to utilize a considerable proportion of the annual earnings for addition to surplus and undivided profits, thus adding to the security and size of the banking institution. The result is that bank stocks customarily sell at a high figure in respect to their dividend return.

After dividends have been declared by the directors of a national bank, they must within 10 days thereafter report of the Comptroller of the Currency the amount of such dividend and the amount of net earnings in excess of such dividend, the report to be attested by the president or cashier.

Liabilities of Directors.—Certain specific liabilities of directors have been created either by provisions of the national banking act or by decisions of the United States courts. They are as follows:

a. Liability for Paying Dividends Out of Capital.—Section 5204, United States Revised Statutes, quoted above, forbids the payment of dividends out of capital. The act goes on to provide:

If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this title, all the rights, privileges, and franchises of the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person shall have sustained in consequence of such violation.

b. Penalty for Falsely Certifying Check.

It shall be unlawful for any officer, director, agent, or employee of any Federal Reserve bank, or of any member bank as defined in the act of Dec. 23, 1913, known as the Federal Reserve Act, to certify any check drawn upon such Federal Reserve bank or member bank unless the person, firm, or corporation drawing the check has on deposit with such Federal Reserve bank or member bank, at the time such check is certified, an amount of money not less than the amount specified in such check. Any check so certified by a duly authorized officer, director, agent, or employee shall be a good and valid obligation against such Federal Reserve bank or member bank; but the act of any officer, director, agent, or employee of any such Federal Reserve bank or member bank in violation of this section shall, in the discretion of the Federal Reserve Board, subject such Federal Reserve bank to the penalties imposed by Sec. 11, subsection (*h*), of the Federal Reserve Act, and shall subject such member bank, if a national bank, to the liabilities and proceedings on the part of the Comptroller of the Currency provided for in Sec. 5234, Revised Statutes, and shall, in the discretion of the Federal Reserve Board, subject any other member bank to the penalties imposed by Sec. 9 of said Federal Reserve Act for the violation of any of the provisions of said act. Any officer, director, agent, or employee of any Federal Reserve bank or member bank who shall willfully violate the provisions of this section, or who shall resort to any device, or receive any fictitious obligation, directly or collaterally, in order to evade the provisions thereof, or who shall certify a check before the amount thereof shall have been regularly entered to

the credit of the drawer upon the books of the bank, shall be deemed guilty of a misdemeanor and shall, on conviction thereof in any district court of the United States, be fined not more than $5,000, or shall be imprisoned for not more than 5 years, or both, in the discretion of the court.[1]

c. Penalty for Embezzlement, Making False Entries in Books, Reports, etc.

Any officer, director, agent, or employee of any Federal Reserve bank, or of any member bank as defined in the Act of Dec. 23, 1913, known as the Federal Reserve Act, who embezzles, abstracts, or willfully misapplies any of the moneys, funds, or credits of such Federal Reserve bank or member bank, or who, without authority from the directors of such Federal Reserve bank or member bank, issues or puts forth any certificate of deposit, draws any order or bill of exchange, makes any acceptance, assigns any note, bond, draft, bill of exchange, mortgage, judgment, or decree, or who makes any false entry in any book, report, or statement of such Federal Reserve bank or member bank, with intent in any case to injure or defraud such Federal Reserve bank or member bank, or any other company, body politic or corporate, or any individual person, or to deceive any officer of such Federal Reserve bank or member bank, or the Comptroller of the Currency, or any agent or examiner appointed to examine the affairs of such Federal Reserve bank or member bank, or the Federal Reserve Board; and every receiver of a national banking association who, with like intent to defraud or injure, embezzles, abstracts, purloins, or willfully misapplies any of the moneys, funds, or assets of his trust, and every person who, with like intent, aids or abets any officer, director, agent, employee, or receiver in any violation of this section shall be deemed guilty of a misdemeanor, and upon conviction thereof, in any district court of the United States, shall be fined not more than $5,000 or shall be imprisoned for not more than 5 years, or both, in the discretion of the court.

Any Federal Reserve agent, or any agent or employee of such Federal Reserve agent, or of the Federal Reserve Board, who embezzles, abstracts, or willfully misapplies any moneys, funds, or securities intrusted to his care, or without complying with or in violation of the provisions of the Federal Reserve Act, issues or puts in circulation any Federal Reserve notes, shall be guilty of a misdemeanor and upon conviction in any district court of the United States shall be fined not more than $5,000 or imprisoned for not more than 5 years, or both, in the discretion of the court.[1]

d. Penalty for Making Political Contributions.

That it shall be unlawful for any national bank, or any corporation organized by authority of any laws of Congress, to make a money contribution in connection with any election to any political office. It shall also be unlawful for any

[1] *Ibid.*

corporation whatever to make a money contribution in connection with any election at which presidential or vice-presidential electors or a representative in Congress is to be voted for or any election by any state legislature of a United States senator. Every corporation which shall make any contribution in violation of the foregoing provisions shall be subject to a fine not exceeding $5,000, and every officer or director of any corporation who shall consent to any contribution by the corporation in violation of the foregoing provisions shall upon conviction be punished by a fine of not exceeding $1,000 and not less than $250, or by imprisonment for a term of not more than 1 year, or both such fine and imprisonment, in the discretion of the court.[1]

e. Penalty for Making Loans to Bank Examiners.

That Sec. 22 of the Federal Reserve Act, as amended by the Act of June 21, 1917, be further amended and re-enacted to read as follows:

a No member bank and no officer, director, or employee thereof shall hereafter make any loan or grant any gratuity to any bank examiner. Any bank officer, director, or employee violating this provision shall be deemed guilty of a misdemeanor and shall be imprisoned not exceeding 1 year or fined not more than $5,000, or both; and may be fined a further sum equal to the money so loaned or gratuity given.[1]

f. Penalty for Receiving Any Fee or Commission for Making Loans, etc.

Except as herein provided, any officer, director, employee, or attorney of a member bank who stipulates for or receives or consents or agrees to receive any fee, commission, gift, or thing of value from any person, firm, or corporation, for procuring or endeavoring to procure for such person, firm, or corporation, or for any other person, firm, or corporation, any loan from or the purchase or discount of any paper, note, draft, check, or bill of exchange by such member bank shall be deemed guilty of a misdemeanor and shall be imprisoned not more than 1 year or fined not more than $5,000, or both.[1]

g. Penalty for Violation of Provisions of Sec. 22 of Federal Reserve Act.

If the directors or officers of any member bank shall knowingly violate or permit any of the agents, officers, or directors of any member bank to violate any of the provisions of this section or regulations of the board made under authority thereof, every director and officer participating in or assenting to such violation shall be held liable in his personal and individual capacity for all damages which the member bank, its shareholders, or any other persons shall have sustained in consequence of such violation.[1]

h. Liability of Directors for Making and Publishing False Report.

Under the decisions of the Supreme Court of the United States in *Thomas* vs. *Taylor* (224 U.S. 73) and of the United States Circuit Court of Appeals in *Chesbrough et al.* vs. *Woodworth* (195 Fed. Rep. 875), when the Comptroller of the Currency has notified directors to collect or charge off certain assets it is a warning that those assets are doubtful, and to disregard such a notice and represent the assets in a statement to be good is a violation of law and renders the directors making the statement liable for damages to one deceived thereby.

The Circuit Court of Appeals in the latter case held that while the duty of charging off such worthless paper was that of the board of directors as an entity, and in such matter the board had a reasonable discretion, yet when the duty existed and was wholly unperformed an individual director who is engaged generally in the performance of his functions may be personally liable because of his participation in the failure to act by failing to make reasonable personal efforts to induce the proper action.

In the case referred to (*Chesbrough et al.* vs. *Woodworth*) the plaintiff bought stock in the bank in reliance upon a false report of its condition and had suffered damage thereby. He was held to have a right of action against any officer or director who knowing its falsity had authorized such a report. The court held that the measure of the plaintiff's recovery would be the difference in the fair valuation of his stock if all of the paper had been of a character entitling it to be reported as assets and that sum which would have been a fair minimum valuation if the directors in the exercise of due care and good faith had charged off the books and not reported so much of the paper as they knew or had good reason to believe was not good and collectible.[1]

i. Liability of Directors for Mismanagement.

The Supreme Court of the United States has held that directors of a national bank must exercise ordinary care and prudence in the administration of the affairs of a bank, and this includes something more than officiating as figure heads. They are entitled under the law to commit the banking business, as defined, to their duly authorized officers; but this does not absolve them from the duty of reasonable supervision nor ought they to be permitted to be shielded from liability because of want of knowledge of wrongdoing, if that ignorance is the result of gross inattention.

It was further held in the same case that the degree of care required of directors of corporations depends upon the subject to which it is to be applied, and each case is to be determined in view of all the circumstances; that the directors of a corporation are not insurers of the fidelity of the agents whom they appoint, and they cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents unless the loss is a consequence of their own neglect of duty.

The United States Supreme Court held, in *Bowerman* vs. *Hamner*, 250 U.S.

[1] *Ibid.*

504, that a director who had never attended a meeting during 5 years' connection with the bank, and who lived 200 miles from the place where the bank was located, was liable for mismanagement because he did not exercise the diligence which a prudent man would usually exercise in ascertaining the condition of the business of the bank or a reasonable control and supervision over its affairs, and that he could not be shielded from liability because of want of knowledge of wrongdoing on his part, since that ignorance was the result of gross inattention in the discharge of his voluntarily assumed and sworn duty.[1]

j. Liability of Directors for Assenting to Excessive Loans.

The United States Circuit Court held (*Rankin* vs. *Cooper et al.*, 149 Fed. Rep. 1010) that it is the duty of directors of a national bank to exercise reasonable control and supervision over its affairs, and to use ordinary care and diligence in ascertaining the condition of its business, which is such care as an ordinary prudent and diligent man would exercise in view of all the circumstances; and that where the directors of a national bank became aware, through the report of a committee of their number, and also by notices sent them individually by the Comptroller of the Currency, that the bank had been making excessive loans to its president and to other persons, firms, and corporations with which he was associated, but took no effective steps to reduce such loans or to prevent their increase, which continued until the bank became insolvent, they will be held jointly and severally liable for all losses which the bank sustained through subsequent transactions, and which could have been prevented by a proper discharge of their duties.

The United States Circuit Court has held (*Witters, Receiver, etc.*, vs. *Sowles et al.*, 31 Fed. Rep. 1) that under Revised Statutes, Sec. 5200, directors of a national bank who make or assent to the making of a loan to any one person of a sum exceeding the legal limit become personally and individually liable for all loss sustained thereby; but where the borrower in such a case is also one of the directors he is not so liable, but simply as a debtor to the bank.

The United States Circuit Court of Appeals in *McCormick* vs. *King et al.*, 241 Fed. Rep. 737, held that directors responsible for excess loans were liable not only for the amount of the excess but for the entire loss thereon with interest, and this case was affirmed by the Supreme Court of the United States in *Bowerman* vs. *Hamner*, 250 U.S. 504.[1]

Directors are prohibited from receiving a larger rate of interest on their deposits than other depositors receive on deposits of a similar character. A national bank may purchase from or sell to its directors securities but only by making full disclosure of the sale and its terms to the Federal Reserve Board, and such dealings can only be by approval of a majority of the board and cannot be on more favorable terms than those offered to others.

[1] *Ibid.*

Although state laws do not as a rule impose by statute the same criminal liability upon directors as do the national laws, nevertheless the civil liability to stockholders and creditors is about the same.

It will thus be seen that the position of director of a bank, whether state or national, entails upon the individual a high degree of responsibility, and requires on his part prudence, foresight, and honesty. The failure of many banks can be directly ascribed to the reckless or careless supervision of the activities of the bank by its directors, and the Comptroller of the Currency has for many years given his best effort to the elimination of negligent administration by national boards. The following statement was published some years ago by the Comptroller of the Currency:

Good Results from Closer Adherence to The Law and Principles of Sound Banking

During the past 5 years this office has endeavored earnestly to impress upon the officers and directors of national banks the importance, not only to customers and depositors of the banks, but also to themselves and their stockholders, of observing strictly the provisions of the National Bank Act, and of conforming closely to the rules and regulations prescribed by the office of the Comptroller of the Currency. This office also has tried hard to keep the directors of all national banks alive to a sense of their moral and legal responsibility for the correct management of the banks. This has been done by direct communications to the banks from this office, and also by arranging to have meetings of directors held at the times of the semiannual examinations by national bank examiners, at which meetings the affairs of the bank are discussed by the examiner with officers and directors, and the attention of those responsible called to features of the management which may be subject to criticism; and suggestions are then made and instructions given with a view to reforming whatever irregularities or unsound practices may be found to exist.

These efforts to maintain an earnest and immediate interest in the management of their banks by officers and directors and to stimulate a desire to correct, avoid, or remove all causes of criticism have been distinctly successful, and it is the opinion of this office that a large part of the present prosperity of the national banks, their immunity from serious losses and failures and the increased and increasing confidence they enjoy, are attributable to the keen and increased personal interest and painstaking attention of directors, supplemented, and perhaps stimulated, by the strict supervision from this office and by the more rigid examinations made possible and facilitated under the provisions of the Federal Reserve Act.

The responsibility of the directors for the examination of the conduct of the bank and the method of such examination will be discussed in the chapter on Bank Examinations.

An excellent and comprehensive statement of the duties of bank directors may be found in the case of *Rankin* vs. *Cooper*, 149 Fed. 1010 (1907), in which Finkelnburg, J., said (pp. 1248 and 1249 of Paton's Digest, Vol. II):

(1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care, in this matter, as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied, and each case must be determined in view of all the circumstances. (5) If nothing has come to their knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors, in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resources of the bank to be made with reasonable frequency.

It is difficult to state the exact degree of care that directors are required to exercise in their management of the bank. They may be responsible for either active or passive negligence. In other words, directors cannot avoid liability for the actions which later resulted in severe losses to the bank, by merely proving that they did not attend directors' meetings. (In one case, though, it was held that illness was a sufficient excuse for passive negligence.)

Directors need not devote themselves to the details of the banking business which may be properly left to the clerks, bookkeepers, and other employees under the supervision of the cashier, but it is negligence on their part to turn over the entire control and activity of the

bank to the cashier or any other officer without on their part exercising a reasonable amount of supervision or oversight.

Directors are not insurers of the honesty and capacity of the employees which they appoint, nor are they liable personally for the acts of their employees which are outside of the scope of their authority, but they are required to exercise due care and diligence in the selection of employees and in supervising their conduct of the bank's affairs. For example, directors have been held liable for (1) failure to hold weekly meetings as prescribed by the laws of the bank, it appearing that they sometimes met only semiannually; (2) allowing a corporation of which one of the directors was president and of which the cashier of the bank was treasurer to overdraw its account many thousands of dollars; (3) lending money to friends and relatives without security; (4) failure to cause the books of the bank to be examined at proper intervals.

While the directors are not trustees in a technical legal sense, they nevertheless have a relationship to the stockholders which is fiduciary in its character, and in the sense that they may not manage the bank for their private advantage when that private advantage conflicts with the interest of the bank and its stockholders. On the other hand, they cannot be held liable for mere errors in judgment unless those errors occurred through mere recklessness or the want of ordinary skill. In accepting the position of director, the individual is considered to hold himself out as possessed of ordinary business skill and ability, and, irrespective of the legal liabilities which may be involved, he should decline to serve if he is not possessed of these qualifications.

References

Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks (1926), Chap. IV.

MAJOR, F. LEE: "The Duties, Responsibilities, and Liabilities of Bank Directors."

CHAPTER V

BANKING ORGANIZATION AND GENERAL POWERS

Under the national banking laws and under the laws of most states no national or state bank can begin business until it has received a certificate to that effect from the Comptroller of the Currency or from the proper officials of the banking departments of the various states.

Prior to the opening of a bank's doors for business to the general public, the bank must go through the necessary steps to organize itself foi the purpose of business operations. The first step in this organization is the election of a board of directors by the stockholders of the bank unless the original board of directors has been named in the organization certificate by the assent of the subscribing stockholders. The national or state laws provide for the method of selection of the first board.

The board having been chosen or elected, as the case may be, meets and organizes. The organization consists of the selection of the officers of the bank and the adoption of the necessary by-laws, designating and fixing the duties of the officers, prescribing the order of business, method of future election of directors, and other matters pertaining to the activities of the officers of the bank.

The officers of the bank, in banking parlance, are those authorized to sign checks and other papers binding upon the bank, and they include the president, one or more vice-presidents, the cashier and assistant cashiers, if there be any, or in state banks and trust companies officers who perform the duties of cashier and assistant cashiers but who may be called by different titles as, for example, treasurer and assistant treasurers. The signatures of those officers authorized to sign for the bank are usually sent to the bank's correspondents with whom the bank will do business.

The President.—Under the national banking laws, the president is selected by the directors from among their own number. Most of the state laws also require that the president of the bank be a director, and even where there is no such requirement under the terms of the state law it is almost universally the custom to select the president of the

bank from among the members of the board. The duties of the president of the bank do not differ in any material way from the duties of the president of any corporation. Unless another officer known as the *chairman of the board* has been selected, it is the duty of the president to preside at meetings of the board of directors. Other than his duty to preside at board meetings he has no power as director superior to the powers of any other director. His specific duties are defined either by the by-laws or by resolutions of the board. He is the executive head of the bank, and as such is responsible to the board of directors for the internal conduct of the bank's affairs. He may or may not take an active part in the daily management of the bank. In some small institutions the president of the bank may be selected because of his reputation in the business world or because of the prestige which he may bring to the bank. He may not be a banker by experience, and he may concern himself but little with the bank's daily operations. In such a case, an experienced banker, usually the cashier, will take charge of the routine business of the bank's affairs, the president largely confining himself to presiding at directors' meetings and building up good will for the bank in his personal and social relationships. On the other hand, many presidents are skilled bankers and take a constant interest in the daily activities of the bank, interview customers, pass upon loans, make credit investigations and supervise the conduct of the bank's employees. Between these two limits there are all possible variations in the degree of activity of the president of the bank, depending upon its size and the president's qualifications. Where the daily activities of a bank are under the sole supervision of one man, whether he be president or cashier, the institution is sometimes known as a *one-man bank*. If that individual is a man of ability and integrity, such banks may be successfully and profitably managed, but generally it is better for the directors to retain a considerable degree of supervisory control, and limit to some extent the sole responsibility of any single individual.

In the matter of detail, the activities of the president of the bank, outside of his duty as presiding officer of the board of directors, is dependent to a very large degree upon the size of the bank. The business of thousands of small banks requires no more than the average time of a single executive officer, and under those conditions the president of the bank may carry on almost any activity. It is related that in some of our smaller Western towns the president may be the first to open the bank's doors for daily business and perform some of the work which is detailed to janitors and watchmen in the larger metropolitan

institutions. In the smaller country banks, the president is frequently a teller during the luncheon period or the temporary absence of the regular teller of the institution. He may be the sole loan officer, passing upon all applications for loans or credit as well as determining, subject later to the approval of the board of directors, the investment of the bank's funds. At the other extreme are the large metropolitan banks, with 15 or 20 vice-presidents, each in charge of a separate department of the bank's activities. Under those circumstances the president may do little detail work, limiting his activities to the initiation of broad policies of the bank, such as the opening of branch offices, the selection of correspondents, both domestic and foreign, and the conduct of negotiations for consolidation or absorption of other institutions. The routine work or the institution is carried on by hundreds of employees, under the immediate direction of the vice-presidents in charge of the various departments.

The exact duties of the president may be defined in the by-laws, but in many cases the by-laws fail to cover all of the activities which may devolve upon the president. In that case the president derives his authority from the actual or tacit approval of the board of directors. The board may specifically limit the authority which the president may exercise. For example, he may be authorized to grant loans up to a limited amount, without receiving the assent of the board of directors or a committee of the board supervising loans. In that case all loans in excess of the amount so specified must be approved either by the board or by the loan committee, as the case may be. In any case, all loans made by the president must be reported to the board of directors at their regular meeting.

The president officially represents the bank so far as the outside public is concerned, and, consequently, in all suits brought against the bank, service of papers on the president is considered by the courts to be adequate service against the corporation. As the president represents the bank in matters of litigation, he has the implied power of employing counsel to advise him in such matters at the expense of the bank. The question occasionally comes before the courts as to the degree of power the president possesses to bind the bank by his actions, without the specific authority of the board of directors or the by-laws. A number of decisions quoted in Paton's Digest, Vol. I, page 119, indicate that:

. . . while the president or vice-president has few inherent powers, they may be authorized by the directors to do anything which the directors may themselves do except such positive requirements as are made personal to the

directors and cannot be delegated. The board of directors need not expressly confer such authority. Usage may suffice to show increased authority. It is sufficient to show the existence of such facts as constitute clearly a holding out to the public that the particular act or contract is within the scope of his legitimate delegated authority. It is sufficient proof of power in a particular respect that the president or vice-president was in the habit of doing things involving the same general power.

The president has the same responsibility as other directors for actions of fraud or negligence resulting in a loss to the bank. He is not responsible, however, for dishonesty or fraudulent actions on the part of other officers undertaken without his knowledge or assent. He is not a guarantor of their honesty and is liable for only reasonable care in their selection, if the duty of selection has been delegated by the board of directors to him.

The president, if an active executive official of the bank, is paid a salary as compensation for his services, the amount of the salary being determined by the board of directors. As the board of directors has the power of appointment of the president, so too, it has the power of removal from office.

Chairman of the Board.—An office known as *chairman of the board* is becoming increasingly common in banking circles, due largely to the process of amalgamation among banks. Where two banks amalgamate, it is quite customary to create this office for one of the presidents, the other president being selected as the president of the institution resulting from the amalgamation. The respective authorities of the president and chairman of the board will in such cases be determined by the by-laws of the corporation or by resolution of the board of directors. As indicated by the title, the chairman of the board acts as such at board meetings. He may in addition have other executive authority delegated to him by the board. As this office is a comparatively recent development, there are as yet few legal cases in which the authority of the chairman of the board has come before the courts.

Vice-Presidents.—All banks have one or more vice-presidents, their seniority being determined either by specifying in their title *first vice-president* or by a resolution of the board of directors or a provision in the by-laws setting forth their rank. The purpose of giving to a group of vice-presidents a specified rank is to determine which among them and in what order they shall have authority to preside over the board of directors or to assume the other duties of the president in his absence. As in the case of presidents, the specific duties of

vice-presidents vary enormously from bank to bank, depending primarily upon the size of the institution. Many small banks have no need for a vice-president except for the somewhat rare case of serving during the illness or absence of the president, or taking his place until a new president is selected in the event of his death or resignation. Under those circumstances a vice-president may be selected from the business or professional community, the vice-president serving for a nominal salary and giving but little of his time and activity to the bank. On the other hand, in the large metropolitan institutions the vice-presidents are numerous and are active executive officials, ordinarily being in charge of either separate branches of the bank or separate departments. Where a bank has a number of large branches, usually there will be a vice-president in charge of each branch. There may be a vice-president in charge of the foreign department, a vice-president in charge of loans, and so on. Under these circumstances the vice-presidents are the executive heads of their departments responsible to the president and board of directors. So far as their delegated authority is concerned, it is governed by the same principles that have been outlined in respect to the authority of the president; that is to say, it is determined by either the by-laws of the corporation, resolutions of the board of directors, or the usage and custom of the bank. An interesting development in the activities of vice-presidents is indicated by the official organization of the First National Bank of Chicago. In this organization customers are classified according to lines of business, and they receive personal attention from officers who are specialists in the financial requirements of these lines through years of training and contact with depositors engaged in kindred business activities. Following is a table indicating the organization of this bank as of June 30, 1928.

Frank O. Wetmore, Chairman — Melvin A. Traylor, President
Edward E. Brown, Vice-president — John P. Oleson, Vice-president

DIVISION A

C. V. Essroger, Vice-president — James B. Forgan, Jr., Vice-president
Norman G. Stockdale, Assistant Cashier
Collateral stocks and bonds — Grain, flour, and feed
Meat products, livestock commission — Coal — Doctors and lawyers

DIVISION B

H. H. Heins, vice-president — Walter M. Heymann, Vice-president
Textiles, clothing, dry goods, furriers, millinery — Transportation
Jewelry, watches, clocks — Department stores — Mail-order houses
Merchandising sundries — Tire manufacturers and rubber goods

Women's Banking Department

O. C. Brodhay, Assistant Vice-president   Charles H. Wood, Jr., Assistant Cashier

DIVISION C

R. Frank Newhall, Vice-president and Cashier   H. P. Snyder, Vice-president

Carl E. Schiffner, Assistant Cashier

Iron and steel   Electrical products   Automobiles
Agricultural implements   Machinery   Plumbing and heating supplies
Hardware   Lumber   Furniture and wood products
Musical and radio instruments   Manufacturing sundries

DIVISION D

Arthur W. Newton, Vice-president   Hugo A. Anderson, Vice-President

Elmer E. Schmus, Assistant Cashier

Petroleum   Public utilities   Real estate
Mortgage bankers   Contractors, cement, brick, stone   Paints, Glass
Hides, shoes, leather products   Wool   Publishing, advertising, printing
Paper and paper products   Instalment financing   Miscellaneous

DIVISION E

William J. Lawlor, Vice-president   Emil A. Stake, Vice-president

Clarence E. Carlson, Assistant Cashier

Groceries, drugs, dairy products, produce commission and cold storage
Sugar manufacturers and dealers   Confectionery, etc.   Tobacco
Maltsters   Beverages   Restaurants   Bakers   Hotels

DIVISION F

John F. Hagey, Vice-president   G. H. Dunscomb, Vice-president

J. P. McManus, Vice-president   T. J. Nugent, Assistant Vice-president

Edward J. Jennett, Assistant Cashier

Banks and Bankers

DIVISION G

A. N. Cordell, Vice-president   G. P. Allmendinger, Assistant Cashier

H. R. Ross, Assistant Cashier

Business Development

FOREIGN BANKING DEPARTMENT

Harry Salinger, Vice-president   William G. Strand, Assistant Manager

G. F. Richards, Assistant Manager

BOND DEPARTMENT

Frank M. Gordon, Vice-president

A. B. Johnston, Vice-president   Walter Lichtenstein, Executive Secretary

Guy W. Cooke, A. V. Dillon, M. J. Hardacre, Albert G. Keck, Assistant Cashiers

AUDITING DEPARTMENT

H. L. Droegemueller, Auditor   J. P. McElherne, Assistant Auditor

CREDIT AND STATISTICAL DEPARTMENT
Edward M. Tourtelot, Assistant Vice-president

DISCOUNT AND COLLATERAL DEPARTMENT
P. M. Riesterer, Assistant Cashier — William Rosbe, Assistant Manager

LAW DEPARTMENT
Harold V. Amberg, General Counsel — John N. Ott, Attorney
C. Edward Dahlin, Assistant Attorney

Vice-presidents are frequently directors, but there is no legal necessity requiring that a vice-president be a director and the practice in this respect varies.

Cashier.—The office of cashier of a bank is far more important than its name would indicate. By long custom, and in some jurisdictions by law, he is the officer in charge of the internal operations of the bank which involve the handling of money and checks. He is the custodian of the bank's funds and is ordinarily the official who is responsible for the proper conduct of the tellers' cages, transit department, and all other departments handling the bank's money. The cashier must be familiar with all the technical details of banking operations. The cashier is generally the officer who employs the clerks, stenographers, bookkeepers and other minor employees of the bank. Unless some other delegation of authority has been made, the cashier is primarily an executive officer responsible for the carrying out of the daily transactions of the bank over which he may have little discretionary power. In some institutions, however, some discretionary activities are specifically delegated to the cashier as, for example, the power to grant loans, generally up to a limited amount.

The cashier being in immediate charge of the bank funds, most laws provide that he be properly bonded in an amount to be approved by the board of directors, with such sureties as the board may direct. Westerfield has outlined the duties of cashier as follows:

1. To draw checks or drafts upon the funds of the bank deposited elsewhere. Checks so drawn are known as "cashier's checks" and are highly valued. Normally the cashier signs himself as "Cashier of the . . . Bank," to show that he is acting in his official capacity and that the check is intended to withdraw corporate funds.

2. To certify checks, unless a check happens to be drawn under unusual conditions. In New York and in the United States courts the right of certification is held inherent in the cashier; but some states deny this. The power of certification may be conferred by the directors on other officers and with such restrictions as the board sees fit to impose. The cashier may not certify checks

of a drawer who has insufficient unencumbered funds, nor may he certify his own checks.

3. To buy and sell bills of exchange; to provide for exchange and for the acceptance of bills.

4. To take charge of the bank's personal property not otherwise provided for by the directors and to dispose of it in the regular course of business, and to keep the accounts of the bank.

5. To indorse and transfer negotiable paper on behalf of the bank in the regular course of business, that is, for discount, collection, payment of the bank's debts, converting collateral security into cash, etc.; he cannot indorse for accommodation nor on his own paper, nor give title to other than negotiable property of the bank.

6. To collect debts due to the bank and perform the necessary incidental operations.

7. To borrow money in the regular course of business and give the bank's note and pledge collateral.

8. To receive deposits and issue certificates of deposit or other evidences.

9. To make or supervise the transfer of the bank's shares of stock.

10. To buy or engage to buy government securities.[1]

The cashier is compensated by a salary determined by the board of directors, and the board may delegate upon him authorities other than those set forth above. In the absence of such a delegation he has no power to bind the bank by his actions outside the customary scope of his authority. He may be assisted by one or more assistant cashiers, depending upon the size of the bank and the extent of the bank's activities. Such assistant cashiers may do all things which the cashier has power to do except that the Comptroller of the Currency has ruled that where the national banking act specifies that the cashier must act, assistant cashiers will not be permitted to take his place.

In trust companies the duties ordinarily falling upon a cashier in the national and state banking systems may be carried on by officers known as *treasurers* and *assistant treasurers*.

In the national banking system the cashier is ordinarily secretary of the board of directors. In trust companies the directors ordinarily select a secretary who is entitled either *secretary of the board* or *secretary of the bank*. Such an official is unknown in the national banking system, the duties of a secretary devolving upon the cashier or his assistants, as the case may be.

Within recent years large urban institutions have often found it desirable to add to the officers of the bank by creating the office of comp-

[1] Westerfield, "Banking Principles and Practice," 2d Ed., p. 405.

troller and of auditor, the duties of which are self-explanatory. It suffices here to state that modern banking practice encourages the daily auditing of the books of the institution so that the directors are familiar with its financial condition, and in order that they may be assured that the accounts have been properly checked.

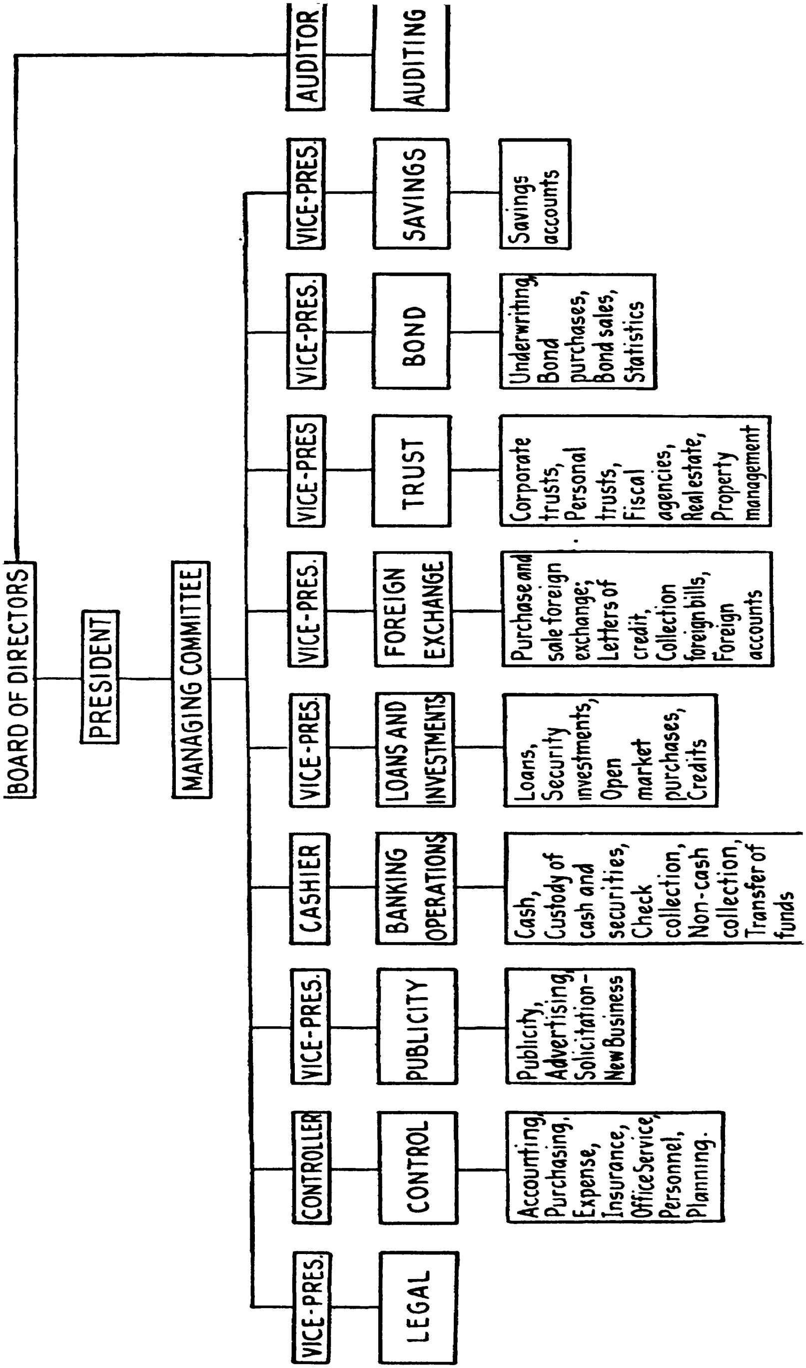
Departments of a Modern Bank.—The great growth in size of banking institutions in this country in recent years, due largely to amalgamations, and the growing tendency of commercial banks to engage in types of business activity hitherto regarded as outside their province have placed upon the banker the formidable task of effectively organizing and integrating the multiple activities of the bank, so that it may function smoothly. In the past, few banks had more than 100 employees. Today the vast majority of banks have even less than that number, but there are numerous institutions whose employees exceed 1,000.

The difference in size of banks, in the nature of the territory they serve, and hence the differences in their activities, make it somewhat difficult to formulate any principles of organization that will be of general application, but certain simple principles and methods have been so developed, that with such modifications as individual conditions dictate, they may be applied with reasonable assurance of success.

Fortunately, banking has always been susceptible to clear-cut division of functions, which makes it possible to develop specialized skill along the various lines of its activities. It admits readily of sharp separation into departments, each department performing clearly defined services; and these services may be further subdivided until the actual work of individuals is of a character that may be performed by workers of average ability. The problems then become those of a proper grouping of related activities, a proper check and evaluation of the work performed, and a proper direction and supervision leading downward from department heads through constant channels to the various employees below.

Following is a chart indicating a typical organization of a large bank.

Modifications in this set up may be made to serve special needs. In some localities the real-estate work of the bank justifies a separate real-estate department, instead of throwing the real-estate work into the trust department, as is here done. Other banks have an extensive and active title department taking care of title searches and the issuance of title insurance policies. Under the savings department, also, generally, come the custody and storage of valuables and the safe-deposit


BOARD OF DIRECTORS
PRESIDENT
MANAGING COMMITTEE
AUDITOR
AUDITING
VICE-PRES.
SAVINGS
Savings accounts
VICE-PRES.
BOND
Underwriting, Bond purchases, Bond sales, Statistics
VICE-PRES
TRUST
Corporate trusts, Personal trusts, Fiscal agencies, Real estate, Property management
VICE-PRES.
FOREIGN EXCHANGE
Purchase and sale foreign exchange; Letters of credit, Collection foreign bills, Foreign accounts
VICE-PRES.
LOANS AND INVESTMENTS
Loans, Security investments, Open market purchases, Credits
CASHIER
BANKING OPERATIONS
Cash, Custody of cash and securities, Check collection, Non-cash collection, Transfer of funds
VICE-PRES.
PUBLICITY
Publicity, Advertising, Solicitation–New Business
CONTROLLER
CONTROL
Accounting, Purchasing, Expense, Insurance, Office Service, Personnel, Planning.
VICE-PRES.
LEGAL

work involving the renting of boxes for the safe-keeping of valuable papers and securities. The investigation of credits, here assigned to the loans and investments department, may have, in some cases, a department, with a separate head.

A type of organization differing somewhat from the foregoing will be required when the bank operates a considerable number of branches. There may be the same division of operating functions, but these are now carried on in different places at the same time. One large bank has met this problem by assigning vice-presidents in charge of functions as before but placing the operating control in each branch in the hands of assistant cashiers, who report to their functional chief. The work of the whole institution is coordinated by a committee of the board of directors, or by an executive vice-president. In some banks each branch is in charge of a vice-president or other officer, and operates almost independently. This would be particularly true when the branch was a foreign branch located at a considerable distance geographically from the parent bank.

Incentives.—The problem of inducing bank employees to give effective and loyal work does not differ in its nature from the similar problem in all lines of business, and a detailed discussion is therefore better suited to a volume on labor management than to the present work. However, certain steps along this line taken by banks may be briefly noted.

In the matter of remuneration, banks notoriously pay low salaries to most of their employees. It is generally contended that superior working conditions, security of employment, and the public prestige attached to bank activities justify a lower wage, but it is probable that in the near future banks will be faced with the necessity of correcting general inequalities of salaries and of raising the average scale of wages.

Considerable work has been done by many banks along the line of training, leading to promotion. Training courses are given by the banks themselves, or the employees are stimulated to enroll in training classes sponsored by the American Institute of Banking, or by local colleges and schools, the banks frequently paying the necessary tuition fees.

Many banks serve lunches to their employees and officers, provide rest and smoking rooms and along similar lines improve the working conditions and environment of their staff.

General Corporate Powers.—Banks have certain general powers which they possess in common with other corporations, resulting from

either the banking laws or general corporate laws of the state of their incorporation or, in respect to national banks, the national banking law and its amendments. These powers under the national banking law are:

First. To adopt and use a corporate seal.

Second. To have succession from the date of the approval of this Act, or from the date of its organization if organized after such date of approval until such time as it be dissolved by the act of its shareholders owning two-thirds of its stock, or until its franchise becomes forfeited by reason of violation of law, or until terminated by either a general or a special act of Congress or until its affairs be placed in the hands of a receiver and finally wound up by him.

Third. To make contracts.

Fourth. To sue and be sued, complain and defend, in any court of law and equity as fully as natural persons.

Fifth. To elect or appoint directors, and by its board of directors to appoint a president, vice-president, cashier, and other officers, define their duties, require bonds of them and fix the penalty thereof; dismiss such officers or any of them at pleasure, and appoint others to fill their places.

Sixth. To prescribe, by its board of directors, by-laws not inconsistent with law, regulating the manner in which its stock shall be transferred, its directors elected or appointed, its officers appointed, its property transferred, its general business conducted, and the privileges granted to it by law exercised and enjoyed.

Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title.

Under the state laws, banks have practically analogous powers, with the exception that there is a wide variance among the states in respect to the right of succession. The corporate life of state banks ranges from 20 years to perpetuity, and in the table in the Appendix appears the maximum life of state banks and trust companies under the present laws of the 48 states. In the state acts, some or all of these powers may be denied to trust companies. The last power mentioned, that of issuing and circulating notes, is specifically prohibited in some states, and is practically prohibited in all states by a Federal law imposing a tax of 10 per cent per annum on the face value of outstanding notes. The practical result of this Federal law is that no state banks issue notes at the present time.

Power to Own Real Estate.—Banks before doing business with the public must acquire banking quarters. This may be done by the purchase or leasing of a building suitable for carrying on the business of a bank. Under the laws of some states, banks are limited in respect to the expenditures they may make for purchasing, leasing, and equipping banking quarters, the limitation imposed having some relation to the amount of the bank's capital and surplus. Most states, however, impose no such limitation, leaving it within the discretion of bank directors as to the initial expenditures for this purpose. Under the laws of all states, banks may own the quarters in which they do business, although many states limit the ownership of real estate by banks in other respects. The national banking law provides as follows:

> A national banking association may purchase, hold, and convey real estate for the following purposes, and for no others:
>
> First. Such as shall be necessary for its accommodation in the transaction of its business.
>
> Second. Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.
>
> Third. Such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings.
>
> Fourth. Such as it shall purchase at sales under judgments, decrees, or mortgages held by the association, or shall purchase to secure debts due to it.
>
> But no such association shall hold the possession of any real estate under mortgage, or the title and possession of any real estate purchased to secure any debts due to it, for a longer period than 5 years.

It is to be noted that under this law national banks may own such real estate as shall be necessary for their accommodation in the transaction of their business. By general tolerance of the Comptroller of the Currency, however, this power has been interpreted to include the ownership by a national bank of a building only part of which is occupied by the bank in the transaction of its business. The bank is permitted to rent the balance of the building. The same interpretation has in the majority of instances been placed upon state laws where those laws limit state banks in their ownership of real estate. In other words, state banks may also in general occupy a portion of the building which they own, and rent the balance.

A bank, having purchased or leased a suitable banking building, equipped it with the necessary facilities in the form of vaults, tellers' cages, furniture and fixtures—including typewriters, adding machines, stationery, books of record, etc.—and having employed the necessary staff for the conduct of its business, is ready to open its doors to the public.

Banks' Indebtedness.—No national banking association shall at any time be indebted, or in any way liable, to an amount exceeding the amount of its capital stock at such time actually paid in and remaining undiminished by losses or otherwise, except on account of demands of the nature following:

First. Notes of circulation.

Second. Moneys deposited with or collected by the association.

Third. Bills of exchange or drafts drawn against money actually on deposit to the credit of the association, or due thereto.

Fourth. Liabilities to the stockholders of the association for dividends and reserve profits.

Fifth. Liabilities incurred under the provisions of the Federal Reserve Act.

Sixth. Liabilities incurred under the provisions of the War Finance Corporation Act.

Seventh. Liabilities created by the indorsement of accepted bills of exchange payable abroad actually owned by the indorsing bank and discounted at home or abroad.

References

HOFF, HARRY A.: "Problems of Bank Organization."

Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks (1926), Chap. VI.

WESTERFIELD, RAY B.: "Banking Principles and Practice" (1-volume Ed.), Chap. XXIV.

CHAPTER VI

THE BANK STATEMENT

As an introduction to a detailed description and analysis of the separate activities of the banking department of a commercial bank, it may be advisable to survey the result of these activities as a whole, as pictured in a bank statement. Partially as a result of common practice, and largely because of the requirements of the law, banks issue and publish, periodically, statements showing, in a summary way, their financial condition. These statements disclose the assets and liabilities of the banks as of a given date, and their publication serves the purpose of assisting stockholders, depositors, and the general public in learning important facts concerning the bank and of giving a basis for a statistical study of banking and credit conditions. In addition, the statements, whether published or not, are of aid to the directors and officers of the banks in determining the liquidity and general condition of their institutions. Statements made for the benefit of the officers, as well as the statements furnished the Comptroller of the Currency and the departments of banking in the several states are generally in greater detail than the published statement.

Such statements contain items similar to those appearing in the following statement, but subdivided in order to enable the reader to more accurately ascertain the condition of the reporting bank. Merely to list under resources an item *Loans and Discounts* does not enable the reader to find out whether the reporting bank has advanced considerable credit on the basis of one name paper, or on paper secured by stock exchange collateral. It does not indicate the liquidity of the paper, whether it consists largely of demand loans or of time loans. This information is necessary if state and banking officials are to learn of the true condition of the bank. Even the more lengthy statements furnished banking officials can be misleading, if care has not been taken to properly evaluate the banks' assets. However a discussion of some of the problems of asset evaluation can be postponed until after the description of the several items appearing in the statement.

There follows the summarized statement, as published, of a national bank of Chicago, one of the largest commercial banks in the United States.

CONTINENTAL NATIONAL BANK AND TRUST COMPANY OF CHICAGO

STATEMENT OF CONDITION, OCT. 3, 1928

Resources		Liabilities	
1. Time Loans	$206,514,486.99	11. Capital	$35,000,000.00
Real Estate Loans	5,599,464.75	12. Surplus	30,000,000.00
Demand Loans	154,272,334.39	13. Undivided Profits	5,182,779.99
Acceptances	25,767.86	14. Reserved for Taxes and Interest	2,300,346.84
2. Bonds, Securities, etc.	66,749,845.57	15. Circulation	50,000.00
	$433,161,899.56	16. Bills Payable with Federal Reserve Bank	27,000,000.00
3. U. S. Bonds and Treasury Notes	50,453,430.35	17. Liability on Letters of Credit	6,945,630.87
4. Stock of Federal Reserve Bank	1,950,000.00	18. Liability on Acceptances	6,065,586.13
5. Bank Premises	10,650,000.00	19. Deposits:	
6. Other Real Estate	248,841.01	Individual . $319,172,159.84	
7. Customers' Liability on Letters of Credit	5,945,050.29	Banks 144,288,987.85	
8. Customers' Liability on Acceptances	4,395,215.78	Savings 49,244,109.79	
			$512,705,257.48
9. Overdrafts	7,881.73		
10. Cash and Due from Banks	118,437,282.59		
	$625,249,601.31		$625,249,601.31

It is to be noticed that, as in all balance sheets—and this statement is a balance sheet—the total of assets equals the total of liabilities, the excess of resources over and above the actual liabilities of the bank to outside creditors being represented by the capital, surplus, and undivided profits.

The individual items will be explained and briefly discussed, beginning with the resources or assets.

ASSETS

1. Loans and Discounts.—In the average statement, the loans are not divided into classes, as is done here, but are simply grouped together under the single title *loans and discounts.* Loans and discounts are assets because they represent debts due to the bank by customers who have borrowed money from the bank and given their notes to the bank, or who have discounted or sold to the bank their own notes or

notes of others payable to them. The essential difference between a loan and a discount is in the time of the payment of interest. Both represent extensions of credit by the bank, but in the case of a loan, interest is paid either at the maturity of the loan or at fixed intervals during its life, as, for example, at monthly or quarterly periods, while, in the case of a discount, interest is deducted at the time the credit is extended.

Specifically, these loans and discounts consist of: (*a*) Loans which have been made by the bank to its customers who have given to the bank, as evidence thereof, their own notes of differing maturities or on demand, either upon the security of their own credit or upon collateral security of various types which may be pledged by them as security therefor. (*b*) Commercial paper, which has been discounted by the bank on behalf of its customers who have received this paper in the course of trade, representing debts due them for the sale of commodities or other economic services. (*c*) Commercial paper, which has been purchased by the bank from commercial paper houses which have underwritten or purchased commercial paper from large industrial establishments for the purpose of providing them with working capital.

In the statement under analysis, the loans are divided into: *a. Time loans* (which include the discounts) payable at some definite future date. These loans may be either secured or unsecured, the statement furnishing no basis for determining the proportion of secured to unsecured loans.

b. Real-estate loans, made on the security of first mortgages on real estate. This item appears in many statements under the heading *Mortgages.*

c. Demand loans, payable on demand and ordinarily secured by the pledge of stocks or bonds. A considerable part of these loans are undoubtedly brokers' loans, that is, loans made to stock brokers on stock market collateral.

d. Acceptances.—This item represents acceptances of banks which this bank has purchased. They are known as *bank acceptances* and are drafts drawn by some individual, corporation or bank (drawer) upon a bank (drawee) and accepted by the drawee. After acceptance and before maturity they are frequently traded in, and are often bought by banks as a temporary investment of funds.

2. Bonds, Securities, etc.—This item represents the various bonds which the bank has purchased for investment. They may be, in any proportions, municipal, state, railroad, industrial, or public-utility bonds and in some statements are so subdivided. Under the National Bank Act, a national bank may not invest its funds in stocks, other

than that of the Federal Reserve bank of its district, or, under certain conditions, in the stock of an institution engaged in financing foreign trade. There is a further exception, in that a national bank may purchase stock which has been pledged with it as collateral on a loan, and which it has purchased to protect itself from loss when the loan was due and unpaid. The bank is then required to dispose of this stock within a reasonable time, but may own some at the time the statement is made up. The term *securities* in this statement would include such items. In other statements, these bonds and stocks may appear under such headings as *Bonds and Stocks*, *Investments*, *Other Investments*, etc. State banks are frequently permitted by law to freely invest in stocks as well as bonds. Banks may purchase these bonds not for investment alone, but for use as collateral security against the deposit of Federal, state or municipal funds.

3. United States Bonds and Treasury Notes.—Practically all banks invest a portion of their funds in the purchase of United States government bonds and notes or certificates of indebtedness issued from time to time by the Treasury Department. These are investments of unimpeachable security, liable only to minor fluctuations in principal value and which constitute valuable collateral if the bank desires to borrow from other banking institutions or from the Federal Reserve System.

The liability side of this statement shows that this bank has notes in circulation amounting to $50,000. Under the National Bank Act, national banks have the privilege of issuing notes, provided they own and deposit with the Comptroller of the Currency as security, United States bonds of certain definite issues. Therefore, at least $50,000 of these United States bonds represent bonds with the circulation privilege, bought (or borrowed) and deposited for that purpose. In some statements they are segregated and appear under the heading *United States Bonds to Secure Circulation.* In that case the balance of the United States securities held would appear under the heading *Other United States Securities.* As state banks do not issue notes, it is unlikely that those issues of government bonds which have the circulation privilege would appear in their statements, because such issues bear a low rate of interest. State banks would probably invest in Liberty Bonds and Certificates of Indebtedness for the purposes above mentioned. They may be utilized as security for government deposits. Banks regard government securities as a primary reserve, that is to say, a reserve which can be converted into cash immediately, without much risk of loss.

4. Stock of Federal Reserve Bank.—National banks are compelled by law to become members of the Federal Reserve System, and as such they are required to subscribe to the capital stock of the Federal Reserve bank of their district, in an amount equal to 6 per cent of the paid-in capital and surplus of the subscribing bank. Of the subscription, 50 per cent must be paid in cash, the remaining 50 per cent being subject to call by the board of directors of the Federal Reserve bank. This bank therefore owns stock in the Federal Reserve bank with a paid-up value equal to 3 per cent of its own capital and surplus. Any change by the bank in the amount of its capital and surplus must be immediately followed by a corresponding adjustment in its ownership of Federal Reserve bank stock, additional subscriptions being made if the capital or surplus is increased, and if lowered, the necessary amount of stock is canceled and returned to the Federal Reserve bank and the subscribing bank is reimbursed for the amount paid therefor.

State banks may join the Federal Reserve System if they desire, provided they meet the requirements of membership. If they become members, they are subject to the same rights and responsibilities as national banks in respect to stock ownership, and this item would appear in their statements.

5. Bank Premises.—This item represents the land and buildings owned and occupied by the bank for banking purposes. It is frequently carried at a nominal figure, as many banks make a practice of writing off a substantial depreciation against their land and buildings annually, in spite of the fact that there may be a very considerable appreciation in the value of the land. This practice results in a concealed asset. Banks are ordinarily very conservative in their valuation of assets, and concealed assets are common. That is one reason why bank stock so commonly sells at a figure considerably above its book value.

Included in the item *Bank Premises* in this statement are the furniture and fixtures of the bank, including the desks, chairs, typewriters, and adding machines, and the other necessary equipment of the bank not attached to and part of the real estate. In many statements there is a separate item to cover these assets, called *Furniture and Fixtures* or some similar term. It is self-explanatory and requires no comment, except the obvious one that substantial depreciation should be annually charged against it. The second-hand value of such articles is small and in case of liquidation little could be realized on them.

6. Other Real Estate.—In the case of national banks, which are not permitted to own real estate, other than their banking quarters, as an investment, this item represents real estate which was offered as

collateral for loans and which has been taken over by the bank to avoid or minimize loss when the loan was unpaid at maturity. This item is carefully watched by the bank examiners and the bank is required to to dispose of it within a reasonable time.

In the case of state banks, the item may represent investments in real estate, if the state laws permit it. Under the laws of many states, no restriction of real-estate investment is placed upon the banks.

7. Customers' Liability on Letters of Credit.—This item represents amounts due to the bank by its customers to whom letters of credit have been issed. Letters of credit are used in foreign travel and in foreign business transactions, and authorize the bank's customer, to whom they have been issued, to draw upon the bank or its correspondents sums up to the amount specified in the letter. The customer agrees to reimburse the bank for the amounts so drawn, and this obligation to pay back the amounts utilized under the letter of credit is an asset of the bank. It is offset by a liability called *Liability on Letters of Credit.* There are types of letters of credit which only authorize others to draw upon the bank issuing the letter. In the chapters dealing with foreign-exchange transactions, letters of credit will be given detailed discussion.

8. Customers' Liability on Acceptances.—This asset is similar in principle to the foregoing item, *Customers' Liability on Letters of Credit.* It represents an obligation of customers to the bank to reimburse the bank for acceptances it has made on behalf of those customers. A bank acceptance is a time draft drawn upon a bank by some other bank or by a business corporation or individual and accepted by the bank upon which it is drawn. The acceptance is indicated by the signature of the proper official of the bank on the face of the draft and constitutes an agreement by the bank to pay the draft at maturity. Such drafts are drawn upon the bank, and accepted by it, as a result of an agreement between the bank and its customer on whose account the draft is drawn. The customer agrees to deposit funds with the bank sufficient to meet the draft when presented for payment. This obligation is an asset of the bank. The customer's debt may be secured or not, according to circumstances. The obligation of the bank to pay the drafts at maturity appears in the statement under the caption, *Liability on Acceptances.*

9. Overdrafts.—Overdrafts come into existence when the bank honors checks on behalf of customers which are in excess of the amounts which the customers have on deposit. The practice of permitting customers to overdraw their accounts is generally criticized by the banking examiners, although it is not illegal. It is ordinarily bad banking prac-

tice to permit overdrafts frequently or in large amounts. Although the depositors owe to the bank the amounts of the overdrafts—which explains why they are listed as assets—nevertheless it is an unsound method of extending credit. An overdraft is practically an unsecured loan. Interest is seldom charged on it, and it is credit extended without the ordinary investigation which should precede the granting of loans. In respect to good depositors whose credit standing is well known to the bank, small overdrafts may be occasionally permitted without serious risk. In this statement the amount is small.

10. Cash and Due from Banks.—This item includes a number of different assets. First, there is the cash in the vaults of the bank—the metallic currency and paper money which the bank must keep on hand to meet its daily needs in cashing checks, making payrolls for customers, etc. There is no standardized amount which a bank should keep on hand for these purposes. Experience arising from local banking practice and the habits and requirements of its customers will determine what sum is necessary to meet current demands. The officers take into consideration the fact that a certain amount of cash will be received daily from depositors. Frequently the cash receipts will equal the daily demand for cash, but for the sake of safety and to meet special demands, such as a large payroll at the middle or end of the month, banks keep on hand more than they are likely to need from day to day. The cash in the vault will probably amount to about 2 per cent of the deposits, although this rule is subject to wide variation. In some statements the item *Cash in Vault* appears as a separate amount in the statement.

Second, the item includes the legal reserve of the bank. In the case of this bank, which is a national bank, the reserve is on deposit at the Federal Reserve bank of the district. The same would be true of a state bank which was a member of the Federal Reserve System. The law fixes the amount of this reserve, which is a percentage of the deposits of the bank. State banks which are not members of the Federal Reserve System are also required by the laws of their states to maintain reserves against their deposit liabilities, some part of which will be deposited with other banks though not with the Federal Reserve banks.

Third, the item includes deposits which this bank has with its correspondent banks. It is customary for banks to deposit sums with other banks in the same community or other communities for the sake of the services which these correspondent banks may perform, and to enable the banks to sell drafts against their accounts in other centers to

customers who may wish to use funds in that form elsewhere. It is frequently profitable for country banks to utilize large New York banks in order to take advantage of the call loan market in New York, or to facilitate the purchase of acceptances or other commercial paper in New York. To accomplish this, the country banks will deposit funds with correspondent banks in New York and the latter institutions will lend or otherwise invest the sums deposited or part of them for the account of the country banks. They will render other services, as well, such as the collection of notes and checks. These deposits, whether with other banks or with the Federal Reserve banks, are demand deposits, and can be realized upon at once. Consequently, they constitute a valuable reserve in case the need suddenly arises for large sums of cash in excess of the amounts kept in the bank vaults.

Fourth, this item includes the checks on other banks which the bank has received from depositors and which have not as yet been collected. These checks are cleared or collected daily or twice a day, but when the statement is made up there will almost always be some checks in the possession of the bank which have not yet been collected. The sums represented are due to the bank by the banks on which the checks are drawn and so are properly listed under *Due from Banks.* In some statements, they are listed separately under the heading *Clearing House Items*, or some similar designation.

Fifth, this item includes cash due from the Treasurer of the United States. This bank has its own national bank notes in circulation, amounting to $50,000. The law requires the bank to keep with the U. S. Treasurer an amount not less than 5 per cent of the outstanding notes for the purpose of redeeming such of the notes as may be presented to the U. S. Treasurer for redemption. In some statements, this item is listed separately under the caption *Cash with U. S. Treasurer* or *Due from U. S. Treasurer.* This asset will not appear in the statements of state or national banks which have no outstanding notes.

LIABILITIES

11. Capital.—This item indicates the amount that the stockholders of the bank have paid in on the shares up to the par or face value thereof. Each bank issues a given number of shares of a given par value. For example, if the par value of these shares is $100, the bank would have outstanding 350,000 shares in the possession of its stockholders. For many years the par value of national banking shares was fixed by law at $100 and for the vast majority of national banks that is

still the par. The McFadden bill permitted other pars, and some national banks have lowered the par value of their shares since the passage of that law. The par value of state bank shares is determined by the laws of the various states as summarized in the Appendix. All banking shares must be fully paid within a short time after commencing business. The item is considered a liability, because it represents an amount which the bank owes to its shareholders in return for the payment they originally made to the bank therefor.

12. Surplus.—This item represents an amount which has been set aside by the bank to supplement the capital invested by the owners. Originally, the bank offered its capital stock to subscribers at a premium, that is, for an amount in excess of the par value of the stock. The excess became a paid-in surplus with which the bank began business. Thereafter, from time to time, in the discretion of the directors, a certain part of the accumulated profits of the bank which had not been paid to the shareholders as dividends and which was carried in the undivided profits account would be transferred to surplus.

There are a number of factors which the directors of the bank must consider in the handling of surplus. It is a practice that is almost universal for banks to pay out in the form of dividends only a fraction of the annual net earnings—sometimes 50 per cent—and to retain the balance to increase the size and strength of the banks and enlarge their lending capacity. There is little argument about the advantage of this conservative policy, but the retained earnings may be handled in a number of ways. They may be carried in an undivided profits account; they may be carried to surplus; or they may be utilized to add to the capital of the bank by the declaration of stock dividends (unless this latter is prohibited by law). Some banks have a policy of keeping capiing capital and surplus small and carrying a large undivided-profits account. Others build up a large surplus, keeping their capital small; still others add to capital from surplus when the surplus exceeds the capital. There is something to be said in favor of all of these variations in policy, depending upon the viewpoint of the bank in question.

Banks which are members of the Federal Reserve System are required to subscribe to an amount of stock of the Federal Reserve bank of their district equal to 6 per cent of their own capital and surplus. If the member bank, therefore, desires to keep down the amount of that investment, it will build up a large undivided-profits account without transferring much of it to capital or surplus. The undivided-profits account is a little more flexible to handle and a substantial amount in undivided profits could be utilized for extra dividends, or to absorb

heavy losses. Banks never like to reduce surplus (except for the issuance of stock dividends to increase capital).

On the other hand, a larger surplus, in relation to undivided profits, increases the legal lending capacity of banks in many jurisdictions. The national banking law, and the laws of some states, limit the amount of loans which can be granted to one borrower to a percentage of the capital and surplus of the bank. In consequence, any increase of capital or surplus increases the bank's lending capacity. If the bank is engaged in trust business, a large capital is frequently advantageous, for both in respect to corporate or individual trusts, the creator of the trust may specify that no bank with a capital less than a given sum shall act as trustee.

Still another factor to be considered is the feature of double liability attaching to the ownership of national bank stock and the stock of many state banks. As the double-liability feature attaches only to the capital stock and not to the surplus and undivided profits, the risk of the stockholders is diminished by having a small capital and a relatively large surplus or undivided-profits account. By the same argument, the safety of the depositors and other creditors is increased by a relatively large capital account. There is here a conflict of interests between the creditors and the stockholders. The Comptroller of the Currency and the various commissioners of banking may recommend to banks the increase of their capital for the benefit of creditors, if the capital seems too small in relation to either surplus or deposits, or to the total assets of the bank.

13. Undivided Profits.—This item has been discussed in relation to surplus. It represents profits of the bank which have not been distributed to shareholders in the form of dividends, and which have not been carried to surplus. It is a fluctuating account, varying from day to day as profits are made or losses suffered. Surplus, however, is unchanged until, at some periodic time, semiannually or annually, the directors decide to increase or reduce it.

14. Reserved for Taxes and Interest.—These are accounting reserves for the payment of Federal and other taxes and accrued interest not yet due and payable. Banks are liable for the payment of income taxes, taxes on real estate owned, and some occasional other taxes. They owe interest on the sums borrowed from the Federal Reserve bank or from other banks, and upon some of their deposits. The taxes and interest are payable on specified dates and a reserve for the payment of these debts when due is properly carried. Some banks carry additional reserves against bad debts and contingencies.

15. Circulation.—This item indicates the amount of national bank notes which this bank has issued and put in circulation. It is offset by at least $50,000 of United States bonds included in the item *U. S. Bonds and Treasury Notes* on the resource side of the statement.

16. Bills Payable with Federal Reserve Bank.—This item shows the amount that the bank has borrowed from the Federal Reserve bank of its district, either on the collateral security of eligible commercial paper, or on United States bonds or Certificates of Indebtedness. As only banks which are members of the Federal Reserve System are permitted to borrow from the Federal Reserve banks, this item would not appear in the statements of non-member banks. Banks may borrow from other banks, however, and an analogous item indicating such interbank borrowing may appear in any bank statement.

17. Liability on Letters of Credit.—This item should be considered in connection with item 7, *Customers' Liability on Letters of Credit.* The bank's liability consists of its agreement to reimburse the banks to which the letters of credit have been presented for the amounts which the customers have drawn. It is worthy of note that the liability of the bank here is greater than the offsetting asset, the liability of the customers. This is no doubt due to the fact that some of the customers have met their liability by paying it to the bank, whereas the bank has not as yet remitted the funds to the institutions which honored the customers' drafts in the first instance.

18. Liability on Acceptances.—This item should be considered in connection with item 8, *Customers' Liability on Acceptances.* It represents the obligation of the bank to honor when presented the drafts which have been drawn upon the bank by agreement, for the account of customers, and which the bank has accepted. The bank's obligation here exceeds in amount the customers' obligations to repay the bank, which indicates that some of the customers have already deposited the funds necessary to take up their drafts at maturity.

19. Deposits.—In this statement, the deposits are divided into three classes—individual, bank, and savings deposits. They are liabilities because they represent obligations of the bank to repay funds which have been deposited with the bank. The individual deposits are demand deposits, that is, they are payable on demand. The order to the bank to pay the funds deposited either to the depositor or to some one else is called a *check.* The deposits come into existence by the depositors' putting, in the bank, cash or checks or notes due and payable, or by the depositors' borrowing from the bank and leaving the proceeds of the loan with the bank for future use. The individual

deposits include deposits of individuals, corporations (other than banks) and partnerships. The bank may or may not pay interest to the depositors on their accounts, depending upon the size and activity of the account and local custom and competition.

The bank deposits, as the name indicates, represent deposits of other banking institutions which are either carrying part of their legal reserves as deposits in this bank, or have deposited funds as correspondent banks for use in the city of Chicago or in the vicinity, or which they may invest in commercial paper, or lend to stockbrokers or invest in securities when the occasion offers. Banks ordinarily pay from 1 to 2 per cent interest on bank deposits.

Savings deposits are time deposits, that is, deposits which may only be withdrawn upon giving to the bank notice of the intention to withdraw, unless the bank chooses voluntarily to permit a withdrawal without notice. The length of time of the notice depends upon the rules of the bank. In the case of national banks, the law has specified 30 days as the length of time for notice, in order to constitute a time deposit. Those who deposit in savings accounts are not expected to withdraw funds at frequent intervals; they are expected to accumulate funds for saving purposes. In consequence, the banks can reasonably expect to use the funds for long periods of time, and they pay interest at an agreed figure on the deposits. The average interest paid today by banks on savings deposits is 4 per cent, although some time deposits not strictly savings deposits, such as certificates of deposit maturing (or payable) at a definite future date may bear any rate of interest (or none) agreed upon between the bank and the depositor.

Most banks receive deposits from the United States government and from the state governments. These deposits are usually separately listed as *Government* or *U. S. Government Deposits.* They are demand deposits upon which interest is generally paid. Banks are not required to receive the deposit of government funds unless they so desire and some banks do not take them, for they are required to put up as collateral security for the deposits bonds of a specified character equal in amount to the funds deposited. On the other hand, most banks take them gladly, because on most of them no reserve need be maintained (a reserve is required against postal savings deposits). Frequently, also, the accounts are inactive, that is, the government withdraws them but rarely, and then generally gives notice of an intention to withdraw, although the notice is not required.

This concludes the discussion of the individual items customarily appearing in the condensed statements of banks. A typical form of a

bank statement for publication, as required by a state law, is appended. It is to be noticed that many of the items which are condensed in the statement herein discussed are subdivided, resulting in a larger number of items. They are self-explanatory, however, and require no comment.

Bank statements such as the one discussed have a rather limited value from the standpoint of determining the liquidity or financial strength of the banks issuing them. They do not disclose enough pertinent facts to enable the reader to find out with certainty the financial condition of the issuing banks. The financial position of banks depends upon the liquidity and value of their assets. The liabilities can ordinarily be taken at their face value. In the statement herein analyzed, more than half of the assets consist of loans, and very little information concerning the quality or value of these loans can be determined

FIDELITY-PHILADELPHIA TRUST COMPANY

LOCATED AT 135 SOUTH BROAD STREET, PHILADELPHIA, PA.

REPORT OF CONDITION AS OF THE 25TH DAY OF MARCH, 1929

Resources

Reserve Fund:	
Cash, Specie, and Notes	$390,630.82
Due from Approved Reserve Agents	6,304,844.02
Nickels and Cents	1,747.25
Cash Items	1,621.62
Exchanges for Clearing House	1,502,243.55
Due from Banking Institutions, Excluding Reserve	2,700,355.82
Bills discounted: upon One Name	2,556,051.00
Bills discounted: upon Two or More Names	117,246.93
Time Loans with Collateral	2,147,664.14
Call Loans with Collateral	52,964,588.61
Loans on Call: upon One Name	4,198,750.00
Loans on Call: upon Two or More Names	37,680.65
Loans Secured by Bonds and Mortgages	554,274.12
Bonds	33,904,437.79
Stocks	4, 671,364.69
Bonds and Mortgages Owned	4,553,957.00
Office Building and Lot	620,531.64
Furniture and Fixtures	2,411,133.52
Other Real Estate	2,527,487.25
Overdrafts	24,320.29
Customers' Liability on Letters of Credit and Acceptances	500,431.08
Other Resources not Included above	6,029,264.77
Total	$128,730,626.56

Liabilities

Capital Stock Paid In	$6,700,000.00
Surplus Fund	21,000,000.00
Undivided Profits, Less Current Expenses and Taxes Paid	4,667,070.34
Demand Deposits:	
Deposits Subject to Check	56,383,198.34
Deposits Commonwealth of Pennsylvania	500,000.00
Deposits U. S. Postal Savings	526,691.80
Certified Checks	24,563.21
Cashier's or Treasurer's Checks	800,113.83
Time Deposits:	
Time Certificates of Deposit	4,807,156.20
Special Time Deposits	12,304,420.02
Time Savings Fund Deposits	10,136,333.47
Due to Banking Institutions, Excluding Reserve	2,251,978.32
Dividends Unpaid	4,026.00
Bills Payable on Time	1,500,000.00
Acceptances Executed and Letters of Credit Issued	500,431.08
Other Liabilities not Included in above	6,624,643.95
Total	$128,730,626.56

from the statement. The loans are listed at their face value, but they may or may not be collectible, either at maturity or at any future date, without some depreciation or loss. This depends upon the nature of the credit investigation that was made by the bank, upon the kind, amount, and quality of the the collateral pledged to secure the loans, upon general business conditions, and upon the specific industries to which the loans may have been made. For example, in agricultural sections during the agricultural depression of some years past, banks had in their statements and in their books loans in large amounts to farmers. In some cases these were secured by the pledge of agricultural commodities such as wheat and other grains in storage. These loans were uncollectible in large amounts for long periods of time, and the value of the collateral had fallen in many instances far below the amount of the loans. Until such loans are written off as losses, they cannot be discovered by an examination of the published statement of the bank.

Not only may the value of the loans be called into question, but their liquidity also cannot be discovered by an analysis of the statement. It is true that demand loans are listed and presumably they are of liquid character, that is, payable upon demand, but it may not be in the power of the bank actually to collect a large proportion of these

loans. The time loans which considerably exceed in amount the demand loans are liquid or not, depending upon their date of maturity and upon whether they are eligible for rediscount with the Federal Reserve bank. This published statement discloses neither the maturity of the time loans nor their eligibility or ineligibility for rediscount, as the case may be.

The statement does not disclose the method of valuing the bonds and other securities carried as assets. Conservative banks write down the value of such securities, if their market price declines, and at the time of publishing their statements value them at the market rather than at cost if the market price is lower. Some banks, however, may not follow this conservative policy, and the statement does not disclose the method of valuation used. In the case of some securities held, it may be of considerable difficulty for the banks to ascertain their valu· , and in such cases they are frequently carried at cost. This is true of unlisted securities for which there is no constant market. Statements of the officers and directors of the corporations issuing the securities may be the only practicable means of valuing such securities at any given time.

The statement does not disclose the method of valuation of the bank premises. Again, most banks adopt a very conservative practice in valuation of their real-estate holdings, but this is not necessarily the case with all banks.

The assets here show a very substantial liability of customers on letters of credit and acceptances. The statement does not disclose whether or not this liability is secured by collateral, nor does it disclose the financial responsibility of the creditors owing these sums to the bank.

In spite of these facts, it must not be thought that bank statements reveal nothing. A number of facts important to depositors and creditors can be ascertained from an examination of the statement. For example, the relationship of cash to demand deposits indicates the immediate ability of the bank to meet any excessive demand of depositors in the nature of a run against the bank. In the statement analyzed, the bank had in cash in its vaults and due on demand from other banks $118,500,000 in round numbers, and against this had a liability of approximately $463,500,000 demand deposits, or a ratio of 26 per cent. This is a very substantial ratio of cash to demand-deposit liabilities, and would give to the bank ample time to realize on certain other assets in case of a run. It would take the paying tellers several days to pay out the sum of $118,000,000 to depositors, and during that time the

bank could realize on other assets. It could call some or all of its demand loans; it could sell some or all of its listed bonds and securities; and it could obtain from the Federal Reserve bank large sums of money by rediscounting such of its loans as were eligible for rediscount. It is ordinarily a proper assumption that a substantial amount of the time loans are so eligible. Another ratio, therefore, which is of importance in determining the liquidity and safety of the bank is the ratio of quick assets, namely, demand loans, cash, United States bonds and securities, and loans eligible for rediscount to demand deposits.

The Capital, Surplus, and Undivided Profits accounts are also of interest in determining the safety of the bank from the standpoint of its creditors. These accounts represent a fund belonging to the stockholders, left by them in the business as a guaranty fund to secure the ultimate payment of the obligations of the bank. In addition to that, the law has imposed upon the stockholders of national banks and many state banks double liability on their bank stock; so that this statement discloses that the stockholders have in the business as a fund to protect the creditors of the bank about $80,000,000, and, in addition to that, the stockholders are liable for another $35,000,000 in case of necessity to pay creditors. The assets of the bank, therefore, would have to be depleted by approximately $115,000,000 before the creditors (exclusive of the stockholders) would suffer loss. Generally speaking, therefore, the larger the amount of capital, surplus, and undivided profits in relation to liabilities, and the larger the amount of capital in relation to surplus and undivided profits, the safer are the bank creditors. Fixed assets, namely, the bank premises, furniture and fixtures, real estate owned, and to some extent the investment securities of the bank should not be too large in proportion to the more liquid assets of the bank, because a very large proportion of the liabilities of the bank, are current liabilities, payable either on demand, or within a relatively short period of time. It has been occasionally stated as a rule of thumb that for a commercial bank the fixed assets and bond and stock investments should not materially exceed the capital and surplus of the bank. This is not cited as a fixed rule which banks should under no conditions violate, but there is, nevertheless, some justification for it in that the capital and surplus representing liabilities to stockholders only cannot be demanded against the bank, and consequently may safely be invested in assets of a relatively fixed and permanent character. On the other hand, most of the other liabilities, being either demand liabilities or payable within a short period of time, should be offset by liquid assets, that is, assets convertible into

cash within a short period of time without material risk of loss. An exception to this rule may be made in respect to savings deposits, as these deposits are payable only after due notice has been given to the bank. It is generally considered proper for a bank to invest an amount roughly equal to its savings deposits in sound securities.

The published statements of banks are widely used for a purpose other than determining the condition of the issuing banks individually. In combination with each other the statements disclose some very pertinent and illuminating facts concerning the state of business and credit conditions of the country, and changes in the combined statements are used for forecasting purposes, both in business and stock-market operations. The Federal Reserve Board in Washington publishes on Friday of each week individual statements, taken as of the close of business on the preceding Wednesday, of the 12 Federal Reserve banks individually, a combined statement for the 12 banks showing the condition of the Federal Reserve System as a whole, and a combined statement representing approximately 700 individual member banks scattered throughout the country in over 100 different cities. These 700 reporting banks send in weekly to the Federal Reserve Board a statement showing their principal assets and liabilities and the Board combines this into a single statement. These 700 banks represent nearly 40 per cent of the entire banking resources of the United States, and their condition thus is a fair index of the general banking condition of the country as a whole. Discussion of this statement and the individual and combined Federal Reserve statements will be reserved for a chapter on the Federal Reserve System.

References

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CHAPTER VII

BANK NOTES

Bank credit as it is used today takes two forms: bank notes and deposits. Bank credit either in the form of notes or deposits constitutes the medium of exchange by which the exchange processes of our business activities are carried on. They constitute the bulk of the currency or medium of exchange of the modern business world. They are supplemented by the notes and metallic currency issued by the Federal government, but the relative importance for exchange purposes, as indicated in the first chapter, is preponderately in favor of bank currency.

In former days, and in some countries at the present time, the great bulk of bank credit used as a medium of exchange was in the form of bank notes. In many of the commercial countries, today, notably the British Isles and the United States, bank deposits circulating in the form of checks have replaced to a large degree the use of notes.

A bank note is an unqualified promise to pay to the bearer on demand a sum of money specified on the face of the note. These notes are engraved, and are of a given size and form as required by the statute laws of the countries in which the banks are located. The right to issue such notes is a matter of legislation in most countries. The law specifies the banks or types of banks having the privilege to issue notes and the conditions under which they may be issued.

In the United States, the only banks having the privilege of issuing notes are the national banks and the Federal Reserve banks. Although there is no specific legal prohibition against the issuance of notes by the state banks, nevertheless a Federal law taxing state bank-note issues has had the practical effect of a prohibition, so that, today, it is frequently stated that state banks do not have the power of issuing notes. It is a fact that there are no state bank notes in circulation in the United States.

The method of issuance of Federal Reserve notes and the principles underlying them will be treated in a chapter on the Federal Reserve

System. In this chapter, the discussion will be confined to the issuance of national bank notes.

Theory of Note Issue.—Under a system of note issue in vogue in this country prior to the passage of the national banking act, and still used in some other countries, note issue is an exceedingly valuable privilege. It was long ago discovered that banks possessing the confidence of the public in their financial soundness could issue their unsecured promises to pay, which would circulate as currency without being returned to the bank for redemption for long periods of time, only small quantities being presented for payment at any given time. As long as the public had confidence that the notes would be acceptable to others as purchasing power, there would be no incentive to change that form of money for any other. Thus a bank possessing, let us say, $10,000 in gold, instead of lending that sum at 6 per cent, or whatever the current rate of interest might be, and receiving an income of $600 per year, might issue notes up to $50,000, if their experience showed that 20 per cent was an ample sum to keep in their vaults to redeem what notes were presented, lend that $50,000 of notes at 6 per cent and receive $3,000 a year income instead of $600. If the reserve maintained was 20 per cent, banks could thus multiply their lending power by five; if the reserve was 10 per cent, by ten, etc. Unless the law fixed the amount of reserve, the banks could exercise their own discretion in the matter, bearing in mind only that the reserve should be sufficient to maintain public confidence, as otherwise large quantities of the notes would be presented at once and the bank would fail if it was unable to realize on its assets with sufficient rapidity to meet the demand. Many of the banks in this country abused the privilege, maintaining insufficient reserves. The notes circulated at varying rates of discount, depending on their distance from the point of redemption, and upon the probabilities of redemption, and many note holders suffered loss. The system was finally abolished here, in favor of the bond-secured currency, thus sacrificing elasticity for security. Under proper safeguards, however, and with conservative management, the system of unsecured bank-note issue may be safely carried on, as it is in some countries today.

National Bank Notes.—National banks are not required to issue notes. It is a matter for the discretion of the officers and directors of the bank, and some national banks either do not issue notes at all, or issue notes in relatively small amounts.

Of the 7,691 reporting national banks on June 30, 1928, there were 6,239 banks with capital of $1,297,741,000 issuing circulating notes, and on the date

indicated the amount of notes outstanding aggregated $649,095,000. The 1,452 banks which did not exercise the circulation privilege had capital stock paid in amounting to $296,115,000.[1]

If a national bank desires to issue notes, it must first procure United States interest-bearing bonds of certain specified issues which have the circulation privilege.

Bonds eligible as security for national bank circulation on June 30, 1928, aggregated $674,625,630, the same as on June 30 of the year previous, and consisted of $599,724,050 consols of 1930 (bearing interest at the rate of 2 per cent per annum); $48,954,180 Panama Canal 2's of 1916–1936, and $25,947,400 Panama Canal 2's of 1918–1938. The Treasurer on June 30 of the current year held as security for national bank circulation $591,220,550 of consols and $74,438,100 Panama Canal 2's, the total or $665,658,650 representing 98.67 per cent of the aggregate of circulation bonds outstanding.[2]

The consols are payable at the pleasure of the United States government after Apr. 1, 1930, on 3 months' notice. The Panama 2's of 1916–1936 are due in August of 1936 but callable at par and accrued interest at the option of the government at any time between 1916 and 1936. The Panama 2's of 1918–1938 are due Nov. 1, 1938, but callable at par and accrued interest at the option of the government at any time between 1918 and 1938.

Method of Issuing Notes.—The national banks which desire to issue notes may either purchase bonds with the circulation privilege, which is the customary procedure, or may borrow them from other banks or institutions owning them; and these bonds must be sent to the Comptroller of the Currency for transfer to, and deposit with, the treasurer of the United States in trust for the association to the account of which they are to be credited. These bonds are thus deposited with the treasurer of the United States as collateral security against the issuance of bank notes and to insure the ultimate payment of the bank notes to the holders thereof in case of the failure of the bank.

National banks may issue their circulating notes to an amount equal to the par value of the bonds deposited, not in excess of the amount of the paid-in capital stock of the issuing bank. The bonds bear interest at the rate authorized under the terms of their issue, and that interest is payable to the order of the bank by the treasurer of the United States. At present the bonds with the circulating privilege bear interest at the rate of 2 per cent per annum. Circulation secured by the

[1] Report of the Comptroller of the Currency (1928), p. 21.
[2] *Ibid.*, p. 18.

deposit of these bonds is subject to a semiannual tax of 0.25 per cent, payable to the treasurer of the United States by the issuing bank. The law also provides that if the circulation is secured by bonds bearing a rate of interest higher than 2 per cent, the circulation shall be subject to a semiannual tax of 0.5 per cent; but this law is inoperative at present, for the former issue of 4 per cent bonds against which circulation was permitted has been retired.

The notes are engraved by the Bureau of Printing and Engraving of the United States government upon an order signed by the cashier of the issuing national bank and directed to the Comptroller of the Currency. That order requests the comptroller to have plates engraved for the bank and have circulating notes printed therefrom, the order specifying the denominations of the notes to be printed and the amounts of each denomination. National bank notes are printed in the denominations of \$5, \$10, \$20, \$50, and \$100. The expense of having the plates engraved and the notes printed is borne by the issuing banks. Formerly, the bank plates cost \$130 each, four notes being engraved on each plate. By recent Federal legislation, the size of the paper money of the United States has been reduced by approximately one-third, enabling more notes to be engraved upon one plate. This may make a slight variation in the cost of the plates.

The signatures of the officers of the banks are now engraved upon the plates, whereas formerly the signatures were placed by hand upon the notes when printed. The notes are forwarded to the banks for issuance.

The banks issue the notes by paying them out across their counters to customers who cash checks or take the proceeds of their loans in the form of currency; or the banks may issue the notes by paying them to their employees as salary, by utilizing them for cash expenditures for materials or supplies, or by settling adverse clearing-house balances with their own notes. In other words, notes when in possession of the bank are utilized by the bank in precisely the same way that any other form of cash would be used by it.

Note Redemption and Retirement.—The notes are payable on demand in legal money of the United States at the office or offices of the issuing bank, and at the Treasury Department in Washington. As the notes circulate at parity with other forms of currency, however, there is no reason why they should be presented for payment, and, as a matter of fact, they are not so presented unless holders desire to convert the notes into gold for some special purpose.

When the notes come into the possession of other banks, they may be utilized by those banks as cash. When the notes become old or worn

out, they are returned to the Treasury Department, where they are either laundered and returned to circulation, or destroyed and new notes printed from the plates to take their places.

National banks may increase their circulation up to the amount of their paid-up capital by the purchase of additional bonds, and by following the procedure of original issuance. They may also retire their circulation by depositing with the treasurer of the United States the sum necessary to pay the outstanding notes, upon which the treasurer of the United States will either sell the deposited bonds for the account of the bank, or return the bonds to the bank.

Security and Redemption Fund.—These notes are amply secured. In the event of the failure of an issuing bank, the treasurer of the United States is authorized to sell the deposited bonds and apply the proceeds to the retirement of the outstanding notes. If this is not adequate, the note holders have a prior lien on the assets of the bank. That is to say, the claims of the note holders would be paid in full before any other creditors of the bank were paid. In the extremely improbable event that the bonds and the assets of the bank were insufficient to retire the notes in full, the note holders would have a claim against the stockholders of the bank, under the double-liability feature of national bank stock, for the sum necessary to pay the notes up to an amount equal to the par value of the outstanding stock.

In addition to the aforementioned security, each bank is required to maintain with the treasurer of the United States an amount equal to 5 per cent of its outstanding notes, for the purpose of redeeming such notes as may be presented to the treasurer for redemption.

Profit of National Bank-note Issue.—The issuance of notes results in small profit to the banks. This is due to the fact that the notes have to be secured up to 100 per cent by the deposit of low interest-bearing bonds. The profit varies with the cost of the bonds to the bank. The various Comptrollers of the Currency have published from time to time calculations of that profit based upon current bond costs. The last official calculation appears in the 1926 Comptroller's Report. The calculations are based on the average monthly cost of $100,000 U. S. consols of 1930 and Panama Canal 2's. Two of the calculations will be reproduced here, taking the months of highest and lowest cost.

This profit calculation assumes that a national bank desires to issue $100,000 of circulation. To accomplish this it must purchase $100,000 of bonds. In February, 1926, consols of 1930 to that amount would have cost the bank $102,977. These bonds bearing interest at the rate of 2 per cent would net the bank $2,000 a year income. The bank must

CONSOLS OF 1930

Date, 1926	Cost of bonds	Circulation obtainable	Receipts			Deductions				Net receipts	Interest on cost of bonds at 6 per cent	Profit on circulation in excess of 6 per cent on the investment	
			Interest on bonds	Interest on circulation less 5 per cent redemption fund	Gross receipts	Tax	Expenses	Sinking fund	Total			Amount	Per cent
February.....	$102,977	100,000	$2,000	$5,700	$7,700	$500	$62.50	$641.44	$1,203.94	$6,496.06	$6,178.62	$317.44	0.308
October......	102,115	100,000	2,000	5,700	7,700	500	62.50	554.87	1,117.37	6,582.63	6,126.90	455.73	0.446
PANAMA TWO'S, 1913–1936													
February.....	$101,415	100,000	$2,000	$5,700	$7,700	$500	$62.50	$98.24	$660.74	$7,039.26	$6,084.90	$954.36	0.941
August.......	100,904	100,000	2,000	5,700	7,700	500	62.50	67.00	629.50	7,070.50	6,054.24	1,016.26	1.007

keep 5 per cent of its issue as a redemption fund with the treasurer of the United States so that of its issue of $100,000 it actually has to lend only $95,000 which at 6 per cent would net the bank $5,700 a year. Thus, the total income to the bank is $7,700 a year. The annual costs are, first, a tax of $500; second, the sum of $62.50, which is an apportioned annual estimate of the costs of the plates and for printing the notes; and, third, a sinking fund of $641.44, which is made necessary by the fact that the bank paid $102,997 for the bonds and in 1930 it will receive back from the government only $100,000. The loss of $2,977 must be apportioned over the years prior to maturity of the bonds. These expenses total $1,203.94, so that the net receipts to the bank are $6,496.06. If the bank had not issued the notes at all but had loaned at 6 per cent the $102,977 which it used to buy the bonds, it would have received annually $6,178.62. So the profit of note issue amounted only to $317.44 per annum, or 0.308 per cent in excess of the 6 per cent which could be earned in either case.

It will readily be seen from these figures that an important consideration is the cost of the bonds. Had they been purchased at par, the sinking fund allowance would not have been necessary and the expenses would have been cut in half. Had they been purchased for less than par, an additional income in the form of profit would have been earned at the maturity of the bonds. Hence, there is a constant incentive to the banks to increase their issues when the bonds are cheap and to retire their issue when the bonds are high-priced. The fluctuations in bond prices may not correspond to the needs of business for more or less currency as the case may be, and in consequence the national bank-note issue has been said by some to be perversely elastic.

Defect of National Bank Notes.—The chief defect of the national bank note is thus its lack of elasticity. Being secured by bonds, the total volume of notes outstanding does not fluctuate easily with differences in business needs for funds. An ideal bank-note currency is one which combines safety with the ability to expand or contract in volume with the varying needs of business, expanding when increasing business requirements call for more currency, and contracting when the need has passed. National bank notes fluctuate in volume according to the price of bonds, rather than in accordance with business needs. There is no automatic retirement, and a glance at the figures of outstanding bonds given above will indicate that substantial expansion is impossible. It is considered now that the Federal Reserve notes provide the elastic portion of our currency and in some circles the national bank note is looked upon as an historic survival of a past banking condition,

having no justification in the currency system of today. It has, however, played a valuable part in our financial history. It replaced the chaotic currency conditions of our era of wildcat banking with a stable and reliable currency, and no problem of depreciated paper money has disturbed the country since its initiation.

Future of the National Bank Note.—It is obvious that the future of national bank-note circulation is highly problematical. In April, 1930, the largest part of the bonds with circulation privilege mature and the balance are payable now at any time at the option of the government. Already agitation has arisen in some quarters to grant the circulation privilege to other government bonds, while many economists and financial writers are viewing with satisfaction the probable cessation of national bank-note issue in the near future.

Following the World War there was considerable sentiment in favor of retiring the national bank notes, and eliminating this form of monev from our currency system. To facilitate this, Sec. 18 of the Federal Reserve Act provided that any member bank desiring to retire the whole or any part of its circulating notes might file with the treasurer of the United States an application to sell for its account, at par and accrued interest, United States bonds securing the circulation to be retired. Under the same section it was provided that the Federal Reserve Board be permitted, in its discretion, to require Federal Reserve banks to purchase such bonds from the banks whose applications had been filed with the treasurer of the United States. The Federal Reserve banks, however, were not permitted to purchase an amount to exceed $25,000,000 of such bonds in any one year. This provision would induce national banks to retire their circulation if the sale of the bonds at par and accrued interest netted a profit to the national bank, as it would, if the national bank had purchased the bonds for less than par. Likewise, if the market price of the bonds at the time was less than par, the price obtainable from the Federal Reserve banks, it might induce the national banks to sell them and retire their circulation in whole or in part. The limitation of $25,000,000 in any one year was designed to prevent any rapid withdrawal of notes, and a consequent temporary shortage of currency.

The following table indicates the variations in the amount of national bank notes from 1924 to 1928 inclusive, as of Nov. 1, of each year:

1924	$774,281,624
1925	713,802,744
1926	700,714,532
1927	702,992,694
1928	700,152,454

The sentiment in favor of the continuation of national bank-note currency is well expressed by Henry M. Dawes, a former Comptroller of the Currency.

Great importance is attached to the circulation privilege by many national banks. It is true that the profits that can be realized as a result of this operation are at the present time relatively small. Under changing conditions this margin of profit might be somewhat increased, so that from the standpoint of earnings the national banks are interested not alone in conditions as they exist at the present time, but in the possibilities for the future.

There is a considerable sentimental value attached to the issuance of currency by the national banks which, because it is intangible, should not be ignored. It is considered by many banks as a symbol indicating their participation in the fiscal policies of the government and an advertisement of the governmental relationship, carrying with it the obvious implications of government supervision and official guidance. Even though it should be conceded that the circulation privilege is of little financial value to the national banks, the fact that many of them feel that in its cancellation a privilege is being taken from them is an important consideration.[1]

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Kilbourne. R. D.: "Principles of Money and Banking," Chap. VI (1927).

Westerfield, R. B.: "Banking Principles and Practice," Chap. VII, pp. 94–107 (1924).

[1] Report of the Comptroller of the Currency (1924), p. 17.

CHAPTER VIII

DEPOSITS

The discussion in the preceding chapter concerning the possible future of the national bank note is of comparatively minor importance. The widespread use of checks as a medium of exchange, their growing popularity and manifold advantages, relegate the bank note to a position of relative insignificance, of use chiefly for change purposes and cash sales. Such elasticity of currency as business and banking require is adequately taken care of by the Federal Reserve notes, and these, and the government issues of money, could suffice for cash requirements of business and the public. In consequence, in the United States, the issuance of notes by commercial banks is becoming a subject of constantly diminishing interest.

Deposits.—From a legal point of view, bank deposits do not differ materially from bank notes. Like the note, a bank deposit is an agreement or contract of the bank to pay to the depositor a definite sum of money. The differences are: (1) in the case of deposits the agreement to pay is either upon demand or after notice for a specified period, depending upon whether the deposit is a demand or a time deposit, while in the case of notes, the agreement to pay is always on demand; (2) deposits may be in any amount, whereas notes are issued in certain specified denominations; (3) the agreement to pay, in the case of deposits is an implied agreement arising out of the legal relationship between the bank and its depositors, whereas in the case of notes the agreement is a written one, embodied in a printed or engraved piece of paper. The agreement to repay a deposit may be printed in a pass book, however, or on a receipt form in the case of certificates of deposit, and the right to demand payment from the bank may be transferred by the depositor to some one else by means of checks either written or partially printed and written. A check is an order signed by the depositor directing the bank to pay on demand, to the legal holder of the check, a sum of money specified thereon. This order may be transferred from one person to another by indorsement and delivery, provided that the form of the check permits such assignment, so that checks may circulate in a manner somewhat analogous to notes. (4) Deposits are not

secured by collateral security, while notes in the United States are so secured in accordance with legislative requirements.

Deposits are created or come into existence as a result of the following transactions:

a. Deposit of Cash.—Customers may deposit, with the bank, cash in the form of metallic or paper money. The forms of such money circulating in the United States and which may be received by the bank are:

1. Gold coins in the denominations of $1, $2.50, $5, $10, and $20. One-dollar gold coins are no longer minted, but many are still in existence. They are seldom deposited, for, on deposit, the bank will give the depositor credit for only $1, whereas, because of their scarcity and historic interest, they are worth to collectors more than $1.
2. Silver coins in the denominations of $1, and 50, 25, and 10 cents.
3. Nickel and copper coins in the denominations of 5 cents and 1 cent.

Coins of other denominations have been minted by the United States in the past, and are still valid and receivable, but like $1 gold pieces they are seldom or never deposited, because of their additional rarity value. Foreign coins are sometimes taken at their exchange value, and on the Canadian and Mexican borders Canadian and Mexican coins may circulate and be receivable at their face value.

4. Paper money in the forms of: (*a*) United States notes, or greenbacks; (*b*) treasury notes of 1890; (*c*) gold certificates; (*d*) silver certificates; (*e*) national bank notes; (*f*) Federal Reserve notes; (*g*) Federal Reserve bank notes.

b. Deposit of Checks.—Banks receive and credit to the accounts of depositors, either at once or after collection, checks on themselves or other banking institutions payable to the order of the depositors.

c. Deposits of Notes and Drafts, etc.—Banks may receive, for collection, promissory notes, drafts, bills of exchange, trade acceptances, postal money orders, travelers' checks, and bonds and certificates of indebtedness payable to the order of the depositors. These the banks will collect at maturity and credit the proceeds to the deposit accounts of the customers depositing them.

d. Deposits of Coupons.—The interest payable on many bonds is embodied in the form of a coupon attached to the bonds which may be cut off and deposited with the bank and on the date payable will be collected by the bank and credited to the depositor.

e. Deposits of the Proceeds of Loans or Discounts.—Customers of banks may borrow from the banks either on their own notes or by discounting the notes or drafts of others payable to them, and instead of

taking away with them in the form of cash the proceeds of these loans and discounts, may leave them with the bank, their deposit accounts being credited with the proceeds of the loans.

Some writers have analyzed these methods of creating deposits and have divided them into two classes—primary and derivative deposits. The first four methods, deposits of cash, checks, negotiable instruments and coupons result in primary deposits, and those arising out of loans are derivative deposits. Primary deposits are so called because they represent new cash or claims upon other banking institutions which can be converted into cash, while derivative deposits, those arising out of loans by the bank, are of a bookkeeping nature, representing no new funds for the bank originating from outside sources. The significance of the distinction between primary and derivative deposits lies in the difference in the effect upon the lending capacity of the bank. Primary deposits indicate a receipt by the bank of new funds which can be loaned. They affect its cash position. Derivative deposits arising out of loans already made do not increase the bank's cash and do not add to its lending power in the same way as do primary deposits.

Deposits are credited to the customers in the books of account of the bank, and the customers receive receipts or evidences of the deposits, if they so desire, in the forms of notations of the amounts deposited, in a *pass book* or *bank book*, which the banks furnish for their depositors, or of duplicate deposit slips; or certificates of deposit.

Pass Books.—Pass books are small blank books, conveniently ruled for the notation by the receiving tellers of the amounts deposited. Entries by the tellers in these pass books constitute *prima facie* evidence that deposits in those amounts were made, but are no more binding upon the bank than any other form of receipt. In case of dispute the banks may introduce evidence that the entries were made by mistake or that amounts other than those appearing therein were actually deposited. Likewise, depositors may introduce evidence to show that deposits were made that were not noted in the pass books or in amounts other than those appearing therein. Many depositors do not take the trouble to use pass books at all, relying upon the bookkeeping systems of the banks, which are generally accurate. Pass books for savings-fund accounts generally contain a printed list of rules and regulations of the bank, defining the terms and conditions under which the deposits are received and may be withdrawn.

Deposit Slips.—Banks furnish their customers with deposit slips upon which to list the character and amounts of the deposits. The

totals of coins and paper currency are stated and each check is listed separately, with the names of the banks or the localities of the banks on which the checks are drawn. The whole deposit is then totaled and these deposit slips are used by the bookkeepers to credit the customers' accounts. If the customer has no pass book and desires a receipt for the deposit, he may make out the deposit slip in duplicate and the receiving teller will stamp or initial the duplicate and return it to the depositor. It constitutes a receipt for the deposit.

Deposits may be made by mail and in such cases the banks mail back to the depositors receipts for the amounts deposited.

A special form of time deposit is known as a *certificate of deposit.* It may be defined as an "instrument issued by banks for funds left on deposit for a stated time or payable on demand." [1]

They may arise out of a number of circumstances. Customers may come into possession of a sum of money which they do not intend to use for a period of time, say 6 months. They desire to obtain a larger interest rate from the bank than they could get if they deposited the sum in their checking account and so they enter into an agreement with the officers of the bank for the receipt of a certain rate of interest and receive a certificate of deposit payable at a definite future date. The banks can afford to pay more interest on such deposit because they know they are going to get the use of the money for a definite period of time, and the reserve they must keep against such a deposit is less than that against demand deposits. Or a bank may consent to make a somewhat risky loan on consideration that the borrower will leave a substantial amount of the loan on deposit with the bank during the life of the loan. This enables the bank to receive a rate of return on the loan in excess of the legal rate. Suppose a customer desires to borrow $100,000 on a security that the bank considers questionable, and, in consequence, the bank considers itself entitled to a return in excess of the legal rate which we will assume to be 6 per cent per annum. The bank agrees to lend the customer $200,000 at 6 per cent and the customer agrees to leave $100,000 on deposit during the life of the loan. The customer receives $100,000 and a non-negotiable certificate of deposit, bearing no interest, maturing at the maturity of the loan. He thus pays an amount equivalent to 12 per cent on the $100,000 that he gets. At the maturity of the loan, he repays the $100,000 and returns his certificate of deposit for $100,000 to cancel his $200,000 obligation.

Certificates of deposit may be negotiable or non-negotiable, accord-

[1] Kniffen, W. H., "The Practical Work of a Bank," p. 258.

ing to their terms. Negotiable certificates may be transferred to others; in the case of non-negotiable certificates, the bank pays the deposit only to the depositor who made it.

When deposits are made in cash, the depositor is not entitled to receive back the identical coins and notes deposited. He is a creditor of the bank for a definite sum of money and the bank's responsibility is completed when a sum equal to the amount deposited plus interest, if interest is paid, is returned to the depositor.

Checks.—Deposit credits are made available as a medium of exchange by means of checks. A check is a written order or draft directing the bank to pay on demand a specified sum of money to the order of some designated person, firm or corporation. For convenience banks have checks printed and supply their depositors with check books containing a number of these blank printed checks. To be valid, however, a check does not have to be drawn on a printed form. It may be written or typ(written on any piece of paper. Checks are seldom so written, as the printed forms are easily available. The forms supplied by the banks have the name of the bank on which the checks are drawn printed on the face of the check. Stationers sell printed forms with a blank for the insertion of the bank's name. Checks are numbered, but the number of the check is not essential to its validity and is for the convenience of the depositor. Each check has a stub in the check book containing the same number and on which the depositor notes the amount and date of the check, the person to whom it is drawn, and perhaps the reason for drawing it.

Date.—Every check should be dated. Although a check is not invalid if it does not contain a date, nevertheless tellers of a bank would be justified in holding up undated checks for inquiry. Such a check may be *stale*, that is, drawn a considerable time before presentation. Although, legally, a check is valid until presented to the bank for payment, unless barred by the statutes of limitations, or unless the drawer has died before presentation, banks will ordinarily not honor checks which are some months old until they have inquired of the drawer whether or not the check is still a valid order on the bank for payment. After all, a check is only an order on a bank to pay money, and the bank is entitled to certainty concerning the intention of the drawer in respect to it. For example, a drawer may revoke the order on the bank by *stopping payment* on the check, provided it has not as yet been paid. This is done by notifying the bank orally or in writing that a described check when presented shall not be honored by the bank. Checks are ordinarily dated as of the day when they are drawn. Checks

dated on Sunday are valid in most jurisdictions, provided they are presented on a week day and during business hours. Checks may be dated some future date. In such cases they do not become valid orders on the bank until their date.

Checks must be drawn in favor of some person, firm, or corporation, or to the order of *bearer* or *cash.* A check drawn to the order of *cash* is used for drawing money out of the bank and in its legal effect is analogous to a check drawn to the order of *bearer.* Ordinarily, banks will not honor checks drawn to the order of *cash* if presented by anyone other than the drawer, unless the one presenting the check is well known to the bank and is representing or acting for the drawer with the knowledge of the bank. The bank does not subject itself to any liability for paying the check to the wrong person, however, by paying cash or bearer checks to the bearer. There is, therefore, considerable risk in drawing cash or bearer checks unless they are for immediate use, because in case of loss or theft they may be cashed by the wrong person and under those circumstances the bank is not responsible. Checks may be drawn in favor of individuals by title, as for example, a check drawn in favor of the *Treasurer of the United States.* Such checks are properly payable to the existing incumbent of that office.

Negotiability.—To be negotiable, checks must be drawn *to the order of* the payee, or to the payee *or order.* If a check is drawn up in favor of a payee alone, the only person who can cash or receive credit for that check is the payee whose name appears on its face. A check drawn *to the order of* a payee, however, may be negotiated or transferred any number of times prior to presentation by indorsement and/or delivery, unless some indorsement destroys the negotiability of the check by limiting its payment to a specified person.

Indorsements are made on the reverse side of the check and may be of different types. A blank indorsement consists of the payee writing his name with no other limiting phrases on the back of the check. Such an indorsement is in effect an order to the bank to pay the check to bearer, and thereafter title to the check may pass by delivery alone. On the other hand, the payee may limit the indorsement by writing on the back of the check *pay to the order of* some designated person. This transfers title to the check to that designated person and to accomplish a further negotiation of the check that individual must in turn indorse it. A blank indorsement on his part will again constitute the check in practical effect a bearer check, or he may in turn limit the indorsement to some designated indorsee, and so on. There is no legal

limit to the number of indorsements and the number of times that a check may be negotiated prior to presentation.

The indorsement of a check has the same effect under the Negotiable Instruments Act as the indorsement of any other negotiable instrument. An ordinary indorsement constitutes not only a transfer of title to the check but a guaranty of its payment in favor of succeeding holders of the check in due course. This guaranteeing of ultimate payment of the check by each indorser can be avoided by an indorsement *without recourse.* This is accomplished by writing the words *without recourse* after the signature of the indorser. Such an indorsement serves to transfer title to the check without guaranteeing its ultimate payment in favor of subsequent holders. Banks require the presenter of a check to indorse it, in order to transfer title to the bank and in order to indicate the person to whom the bank paid the money.

It is not legally necessary that a bearer or cash check be indorsed and if the banks are cashing such checks for a person well known to them, the indorsement may not be required. Ordinarily, however, banks will require such an indorsement in every case except in the use of *counter* checks drawn to the order of cash and presented by the drawer to the bank on which the check is drawn. Banks will cash checks drawn on other banks in favor of individuals known to them, the indorsement in such case being a guaranty by the presenter that the check will be paid by the bank on which it was drawn. If the check is not so paid upon presentation, the bank cashing the check for its customer has recourse against that customer for reimbursement. If the customer is a depositor, as is generally the case, the banks will ordinarily charge his account and notify him of the non-payment of the check.

In order to be a valid negotiable instrument, a check must be an order for the payment of a definite and specified sum of money. The sum to be paid appears ordinarily in two places on the check. It is written out on the face of the check in the proper blank space for that purpose and it also appears in figures at some place on the face of the check. If there is a variation between the written sum and figure sum, the bank would be justified in paying the lower of these two figures; but, ordinarily, it would inquire of the drawer as to which of the two amounts was correct.

Checks should be carefully drawn to prevent alteration of the amount. The written sum should start at the left side of the space allotted for it, close enough to the side of the check to prevent the inser-

tion of any other figure, and blank spaces at the end of the written sum should be filled in by an inked line. A number of mechanical devices for stamping, or printing on the check, or perforating it with the sum drawn, are on the market and are used by many individuals and business houses. It is not legally necessary, however, that such a device be utilized, and a bank is responsible for the payment of any raised, altered, or forged check which is properly drawn in writing.

Signature.—Checks must be signed by the payee or some person acting for or on behalf of the payee under a properly executed power of attorney authorizing the act. Such powers should be filed with the bank in order to indicate to the bank the authority of the attorney so appointed to sign checks on behalf of the depositor.

Counter Checks.—Counter checks have been referred to above. They are printed blank forms placed in the desks or counters for the use of depositors who usually withdraw sums from the bank in cash. There is printed upon them *pay to the order of cash* with blank spaces for filling in the amount, date and signature. Generally, the word *non-negotiable* is printed on the face of the checks and they are for use only within the bank itself for the immediate withdrawal of funds.

Opening Deposit Accounts.—A person desiring to open a checking account with the bank consults with the officer designated for that purpose, generally the cashier or an assistant cashier of the bank. References may sometimes be required, as banks do not care to receive deposits and carry deposit accounts for individuals of questionable character who may misuse their privileges. Some banks will not accept checking accounts unless the amount deposited is some minimum figure fixed by the rules of the bank, or unless the depositor's average balance will amount to some designated figure. To open the account, the depositor signs signature cards with the name that will be used on the checks in drawing against the account. These signature cards can be used by the tellers for reference to determine the validity of signatures appearing on checks presented to the bank. Checking accounts can be opened in the names of two or more persons under conditions which permit any of them to draw against the account. The signatures of all those having a right to draw against the account will appear on the signature cards. If the account is opened in the name of a partnership, corporation, or other association, the signature cards will contain the names of those officers who must sign the checks of the partnership, corporation, or association, as the case may be.

The new depositor, having signed the signature cards, makes an initial deposit and receives from the bank a pass book and blank check

book. Blank check books of different types to suit the convenience of the depositor are furnished by the banks, generally at the bank's expense. These checks may contain the printed name of the depositor, and in other respects be drawn in such fashion as he designates.

Savings accounts are opened in the same way as checking accounts, except that in respect to savings accounts the pass book will indicate the terms and conditions under which the account is accepted, as, for example, the time period of notice required in case of withdrawal from the account. Withdrawals from savings accounts are made in some instances by check; in most cases, however, by signing a form of receipt for the sums withdrawn.

Some banks receive small accounts with limited checking privileges, the depositor, for example, being limited to some designated number of checks a month. The honoring of checks entails certain expenses of handling to the bank and if the average balance is small, the account may actually result in a loss. This will be particularly true if it is an active account against which a large number of checks are regularly drawn. This expense feature is the reason for such limited accounts.

Interest on Deposits.—Payment of interest on deposit balances is a matter of considerable variation among the banks. It is the universal practice to pay interest at a fixed advertised rate upon savings deposits. This rate varies from one section of the country to another but is generally constant in any locality, either by agreement among the banks or by the force of competition. In addition, banks generally pay a small interest on checking accounts provided the average balance maintained in the account exceeds a certain sum, say $500. Some banks pay interest on checking accounts only if it is earned; that is to say, if the expense of handling the account does not exceed the profit derivable to the bank from lending the sums of money in the account. Under those conditions, an account having an average balance of $5,000 or more might not be profitable if the account entailed upon the bank the responsibility of honoring or collecting very large numbers of items. In the case of certificates of deposit, the interest payable on the account is a matter of negotiation between the depositor and the bank, and will vary with the size and maturity of the deposit and the conditions under which it was made. Deposits of municipal and state governments and the Federal government and deposits by other banking institutions almost always bear interest, sometimes at a rate slightly higher than the rate paid to individual depositors. This is particularly true of government deposits. For example, banks have to pay interest at the rate of 2½ per cent on postal savings deposits.

Advantages of the Use of Checks.—It has been stated that, in many commercial countries, deposit currency in the form of checks has replaced to a large degree the use of currency, whether issued by banks or by the government. The reasons for this are not far to seek. There are certain manifest advantages in the use of checks as a medium of exchange.

a. Safety.—The use of currency, particularly in transactions by mail, involves considerable risk of loss and theft. If currency is lost or destroyed by fire, wreck, or other accident, the loss is likely to be final, subject to no recovery except in so far as it may be covered by insurance. If currency is stolen, it passes freely from the hands of the thief to other innocent holders and is generally impossible to trace or recover. Checks are not susceptible to the same risk. If a check is burned or lost it may be replaced by simply drawing another check with proper precautions to secure the cancellation of the lost or destroyed check. If checks are stolen, unless they are *bearer* or *cash* checks they cannot be utilized by the thief without forgery, which throws the responsibility upon the banks paying them rather than on the depositor. It is, therefore, obvious that checks constitute a safer medium of exchange from the standpoint of the drawer of the check.

b. Receipt.—Checks constitute a receipt and permanent evidence of the fact that payment to the amount of the check has been made to someone. If a bill is paid by means of currency, the transaction itself is not susceptible to later proof, unless a written receipt was given by the recipient of the money, or unless the payment was made in the presence of witnesses. This is particularly true if the recipient of the payment dies. In the absence of a written receipt or evidence of other parties, proof of the payment cannot be made, as the payer is barred by the laws of evidence in most jurisdictions from giving oral testimony of his payment where the recipient is dead and, therefore, of course cannot deny it. In payment by check, on the other hand, the indorsement of the payee constitutes a written acknowledgment of the receipt of the money provided the check has been honored by the bank on which it is drawn. When paid by the bank the check is either stamped or perforated *paid* and is returned to the drawer and may be retained by him as permanent written evidence that the payment in that sum has been made and the funds received. In order that the purpose of the payment may be ascertained, it is customary and excellent practice to write upon the face of the check the purpose for which the check was drawn, which gives added value to that check as a receipt or evidence of payment for a specific purpose.

c. Stop Payment.—If payment is made in currency either in error or in a sum different from the actual amount owed, the mistake cannot easily be rectified. A legal proceeding may be necessary to recover the sums paid in error and if the recipient of the payment is insolvent, the sums may never be recovered. On the other hand, if a payment is made in error by means of a check, the drawer of the check may by proper notice to the bank stop payment of it prior to its presentation to the bank upon which it was drawn, so that when the check is presented the bank will refuse to honor it. This is also a valuable precaution which can be adopted in case of a lost check, provided that the notice is received by the bank before it has honored the check. The check is valueless in the hands of anyone who may have stolen it, found it, or received it in error.

d. Odd Amounts.—Currency circulates in certain specific denominations and odd amounts are made up by the use of metallic currency or change. It is highly inconvenient to send through the mail such a sum as $59.76. It would require a fifty-dollar bill, a five-dollar bill, four one-dollar bills, a fifty-cent piece, a quarter and a penny, altogether quite a bulky package. That sum can be as readily transmitted as any other sum by means of a check.

e. Large Amounts.—Somewhat analogous to the preceding advantage is the fact that very large amounts may be transmitted by check with ease and safety. Any sum whatever can be written on the face of the check, whereas to send a very large amount in currency may require trucking facilities and involve considerable expense in shipment and insurance.

It must not be inferred from this that checks will ever entirely replace currency in public use. Currency will always be valuable for making small cash purchases. We can hardly conceive of the payment for a two-cent newspaper by means of a check or drawing a check in favor of the conductor of a trolley car or bus when we wish to ride down town. Furthermore, checks will only be received by individuals who have confidence that the drawer of the check is the person he purports to be and has an account sufficiently large to make the check good at the bank on which it is drawn. Therefore, checks are not available as a medium of exchange in transactions involving the immediate delivery of goods between people who do not know each other, as in the purchase of goods at retail stores, where the stores deal with any member of the public who comes in to buy. Checks, however, are widely used in retail purchases when the customers have charge accounts at the stores and settle these accounts monthly or at other intervals.

Checks, too, are not so popular in communities where banking facilities are meager. They are also not widely used among the poorer classes, because many banks refuse to accept checking accounts where the average balances maintained are small. This difficulty is overcome by some large employers of labor in this country by the establishment of banking facilities in connection with the business where salary checks may be deposited or cashed by the employee. Incidentally, the practice of paying salaries by check is growing in this country, particularly in communities where the workers can cash the checks with little difficulty.

The main advantage of currency over checks, of course, is the knowledge on the part of the recipient that currency is good for its face value, subject to the very minor risk of counterfeiting, whereas a check is only good if the depositor has an account of sufficient size at the bank upon which the check is drawn and if the check is properly drawn. A very large number of checks are returned daily by the banking system of the country for *lack of sufficient funds*, *no account*, or *improperly drawn*.

CHAPTER IX

DEPOSITS (*Continued*)

Reserves.—All banks, whether national or state, must maintain a reserve against their deposit liabilities. In the United States this requirement is invariably a legal one, the amount, character, and location of the reserve being fixed by statute law. In England, and some other countries, the amount, character, and location of the reserve is left to the discretion of the banks.

For the National Banking System, and all banks which are members of the Federal Reserve System, the reserve requirements are fixed by Secs. 19 and 20 of the Federal Reserve Act as amended. The amount of reserve varies, depending upon the location of the bank, and upon whether the deposits are demand deposits or time deposits, which are defined by the act as follows:

> Demand deposits within the meaning of this act shall comprise all deposits payable within 30 days, and time deposits shall comprise all deposits payable after 30 days, all savings accounts and certificates of deposit which are subject to not less than 30 days' notice before payment, and all postal savings deposits.
>
> Every bank, banking association, or trust company which is or which becomes a member of any Federal Reserve bank shall establish and maintain reserve balances with its Federal Reserve bank as follows:
>
> *a.* If not in a reserve or central reserve city, as now or hereafter defined, it shall hold and maintain with the Federal Reserve bank of its district an actual net balance equal to not less than 7 per cent of the aggregate amount of its demand deposits and 3 per cent of its time deposits.
>
> *b.* If in a reserve city, as now or hereafter defined, it shall hold and maintain with the Federal Reserve bank of its district an actual net balance equal to not less than 10 per cent of the aggregate amount of its demand deposits and 3 per cent of its time deposits: *Provided, however,* That if located in the outlying districts of a reserve city or in territory added to such a city by the extension of its corporate charter it may, upon the affirmative vote of five members of the Federal Reserve Board, hold and maintain the reserve balances specified in paragraph (*a*) hereof.
>
> *c.* If in a central reserve city, as now or hereafter defined, it shall hold and maintain with the Federal Reserve bank of its district an actual net balance equal to not less than 13 per cent of the aggregate amount of its demand deposits

and 3 per cent of its time deposits: *Provided, however*, That if located in the outlying districts of a central reserve city or in territory added to such city by the extension of its corporate charter, it may, upon the affirmative vote of five members of the Federal Reserve Board, hold and maintain the reserve balances specified in paragraphs *a* or *b* thereof.

There are two central reserve cities in the United States to which the 13 per cent requirement applies. These are New York and Chicago. The reserve cities at the date of writing are as follows:

RESERVE CITIES [1]

June 30, 1928

Boston	El Paso	Peoria	Topeka
Albany	Fort Worth	Detroit	Wichita
Brooklyn and Bronx	Galveston	Grand Rapids	Helena
Buffalo	Houston	Milwaukee	Denver
Philadelphia	San Antonio	Minneapolis	Pueblo
Pittsburgh	Waco	St. Paul	Muskogee
Baltimore	Little Rock	Cedar Rapids	Oklahoma City
Washington	Louisville	Des Moines	Tulsa
Richmond	Memphis	Dubuque	Seattle
Charlotte	Nashville	Sioux City	Spokane
Atlanta	Cincinnati	Kansas City, Mo.	Portland
Savannah	Cleveland	St. Joseph	Los Angeles
Jacksonville	Columbus	St. Louis	Oakland
Birmingham	Toledo	Lincoln	San Francisco
New Orleans	Indianapolis	Omaha	Ogden
Dallas	Chicago	Kansas City, Kan.	Salt Lake City

Banks located in all other parts of the United States are called *country* banks and are subject to the 7 per cent reserve requirement.

The entire reserve of member banks must be deposited with the Federal Reserve bank of their districts. State banks and trust companies which are not members of the Federal Reserve System are subject to the reserve requirements of their respective states. Space does not permit a discussion of each separate state law, but a summary of the reserve requirements of all states as of the date of its publication appeared in the *Federal Reserve Bulletin*, November, 1928, Vol. 14, pages 778–805.

Method of Calculating Reserves.—National banks located in central reserve cities and in reserve cities where a Federal Reserve bank or branch is located, file semiweekly reports as a basis for reserve computation with the Federal Reserve bank of their districts. In Philadelphia

[1] Report of the Comptroller of the Currency (1928), p. 28 and 29.

these reports are made as of the close of business each Tuesday and Friday.

Other reserve city banks file reports on a weekly basis.

Country banks file reports semimonthly, at the close of business the fifteenth and last day of each month.

Following is a form filled in with hypothetical figures indicating the method of reserve computation.

Computation of Reserve to be Maintained by Member Banks with the Federal Reserve Bank

Demand Deposits

1. Deposits, except Bank and U. S. Government, due in 30 days or less or subject to less than 30 days' notice (total of schedule K in the quarterly condition report)		$20,500,321
2. Due to Banks:		
a. Due to Federal Reserve Bank (deferred credits)	$450,336	
b. Demand Balances Due to Other Banks and Trust Companies in United States	3,451,205	
c. Certified and Cashier's or Treasurer's Checks, including Dividend Checks, Outstanding	76,462	
d. Demand Balances Due to Banks in Foreign Countries		
e. Letters of Credit and Travelers' Checks Sold for Cash and Outstanding	126,490	
f. Total Due to Banks (total of schedule J in the quarterly condition report)	4,104,493	
3. Due from Banks:		
a. Items with Federal Reserve Bank in Process of Collection	$326,401	
b. Due from Banks (other than Federal Reserve banks) and Trust Companies in United States. (Do not include any amounts not subject to withdrawal without notice)	2,232,500	
c. Exchange for Clearing House and Other Checks on Local Banks	241,320	
d. Balances Payable in Dollars Due from Foreign Branches of Other American Banks		
e. Total Due from Banks (total of items 4 to 8 in Schedule I)	2,800,221	
4. Net Balance Due to Banks (Excess of item 2*f* over item 3*e*; if "Total due to banks" (item 2*f*) is less than "Total due from banks" (item 3*e*), both amounts must be omitted from the calculation)		$1,304,272
5. Net Demand Deposits (item 1 plus item 4)		21,804,593

Time Deposits

6. Deposits, Payable after 30 days or subject to 30 days' or more notice, as defined in Federal Reserve Board regulation D; and postal savings (total of schedule L in the quarterly condition report)	$4,320,461

Reserve Required

On Net Demand Deposits (item 5 above): banks in central reserve cities, 13 per cent; banks in reserve cities, 10 per cent; banks elsewhere, 7 per cent (10%)	2,180,459
On Time Deposits (item 6 above): 3 per cent	129,614
Total Reserve to be Maintained with Federal Reserve Bank	$2,310,073

In submitting reports of demand and time deposits subject to reserve, on the report copy made up for each day, the banks report the daily deposits subject to reserve. At the end of the period, these daily figures are totaled up and divided by the number of days in the report period. The Federal Reserve Act says nothing about averaging, but provides that the proper reserve shall be held and maintained each day. The regulations, however, provide for averaging for the purpose of convenience in assessing penalties for deficiencies in reserves. The reserves themselves are treated in the same manner as deposits. The daily balance is set down each day during the period, an aggregate total is made and divided by the number of days in the report period, to establish an average daily balance for the period. This average is then compared with the reserve required on average deposits for the period.

If the reserves have been insufficient, the regulations call for a penalty upon the delinquent banks equivalent to an interest charge of 2 per cent per annum above the 90-day discount rate in effect on the first day of the calendar month in which the deficiency occurred. Banks whose reserve requirements are calculated semiweekly, when deficient for 12 consecutive semiweekly periods (approximately 1½ months), are assessed in addition to the penalty at the basic rate, a progressive penalty on semiweekly deficiencies occurring thereafter, until such banks have maintained the required average reserve for eight consecutive semiweekly periods (approximately 1 month). The progressive rate is one-eighth of 1 per cent in addition to the basic rate, increasing by this amount for every subsequent deficiency. Banks whose reserve requirements are calculated semimonthly, when deficient for three consecutive semimonthly periods (approximately 1½

months) are assessed a progressive penalty in addition to the basic rate until reserves have been restored for two consecutive semimonthly periods. The progressive penalty is one-half of 1 per cent, increasing by this amount for each subsequent deficiency.

The purpose of maintaining a reserve is, of course, to keep a fund on hand to honor demands against the deposit accounts by the depositors. Therefore, the reserves may and should be used when necessary. The Federal Reserve Act provides:

> The required balance carried by a member bank with a Federal Reserve bank may, under the regulations and subject to such penalties as may be prescribed by the Federal Reserve Board, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities: *Provided, however*, That no bank shall at any time make new loans or shall pay any dividends unless and until the total balance required by law is fully restored.

In most banks the average amount of cash daily received over their counters will about equal the average amount of cash paid out, except at certain periods, say the middle or end of the month, when large payrolls may result in a net loss of cash. Following the payments, when the workers are returning the cash either directly or through the retail stores of the community, there may be an excess receipt of cash. Likewise, from day to day there is a tendency for the receipt of checks to just about balance the checks drawn against that bank. This, again, will vary, depending upon the time, season, and nature of business of the banks' customers. During normal periods of activity, however, very little use of the reserve need ordinarily be made. Its chief purpose, today, is to settle adverse clearing balances, and to meet the infrequent runs against banks which occasionally occur. The improvement in our methods of clearing which has tended to reduce bank requirements for the settlement of adverse clearing balances, improvements in our systems of bank examination and control, and the organization of the Federal Reserve System—designed among other things to make additional reserves speedily available to the banks—have made it possible to materially lower the reserve requirements of this country, and by so doing create large quantities of additional potential credit.

Primary and Secondary Reserves.—It has been the custom of banking writers to divide the assets of a bank into a number of categories for the purpose of ascertaining what proportion of the assets of the bank might be readily utilized to meet sudden liabilities of the bank, chiefly runs against the institution. Those assets which can be most readily converted into cash to meet demand liabilities have been

called *primary reserves,* and those assets which can be converted into cash only after some period of time have been called *secondary reserves.* In addition, there are certain assets which can hardly be liquidated at all without completely winding up the bank's affairs, such as, for example, the banking house and stock in the Federal Reserve bank, which are not counted as reserves at all.

There is no completely uniform agreement among writers as to what constitutes primary and secondary reserves, and in fact there is no sharp dividing line between them. Primary reserves are frequently said to consist of: (1) cash in vaults; (2) demand deposits with the Federal Reserve bank or other banking institutions; (3) demand loans; (4) time loans eligible for rediscount with the Federal Reserve bank. Some writers list United States securities as primary reserves, because they can be immediately liquidated by sale on the exchanges with but slight risk of loss due to variation in the principal value of the security. If United States securities are so considered as primary reserves, there seems to be no reason why municipal and state securities and certain of the standard bonds of large industrial and railroad companies should not also be considered as primary reserves, for these securities are also listed. There is a steady demand or market for them which would enable them to be sold at once and for many of them the risk of fluctuation does not differ materially from the risk of fluctuation of government securities. One reason, however, which would justify the listing of government securities as a primary reserve to the exclusion of state, municipal, and sound industrial and railroad issues would be the fact that the government bonds can be utilized as collateral security for loans from the Federal Reserve bank, whereas the other securities cannot. From the standpoint, however, of liquidation by sale, it seems that no legitimate distinction can be drawn.

Secondary reserves consist of time loans payable within relatively short periods of time, mortgages which are about to mature, and bonds and other securities currently listed on the exchanges, if these have not been included in the primary reserves. The facilities offered by the Federal Reserve System for rediscount and loans on security, together with the active markets on the exchanges, make it possible for the banks to realize with great rapidity on a very large proportion of their assets, particularly if the bank is located in a commercial community and has a wide assortment of loans and investments. Of recent years, the banks which have failed to maintain the liquidity of their assets have been chiefly banks in agricultural communities. Their geographical location and the nature of the customers' business make it necessary

for them to invest the greater proportion of their assets in agricultural loans of certain types. Any depreciation in the agricultural industry or sudden fall in price of important agricultural commodities is very likely to involve such banks in financial difficulties.

The Theory of Bank Credit.—The two facts, first, that the vast majority of the loans extended by banks result in deposit accounts, and secondly, that banks are required both by law and in practice to maintain against their deposits only a fractional amount thereof as a reserve, have led writers on banking to express the opinion that a bank can lend many times the amount of its cash deposits.

A study of the combined statements of the banks of the United States, as in the following table, shows that the banking system has extended loans to an amount in excess of ten times the reserves maintained by the system, and a study of any individual bank's statement will disclose approximately the same condition.

As it is apparent that the banks have succeeded in lending a multiple of their reserves, it is frequently stated that any addition to the reserve fund of a bank will enable that bank to extend loans to the same multiple. For example, if a bank has loans of $5,000,000 and reserves of $500,000 showing a ratio of 10 : 1, it is assumed that any additional reserve money will enable the bank to extend loans to ten times that amount.

Statements analogous to this appeared in most banking texts until the publication of a volume entitled "Bank Credit," by Chester A. Phillips, in which that theory was attacked and another theory advanced, namely, that a bank upon the receipt of an addition to its reserve fund can lend an amount only slightly in excess of the new amount so received. Mr. Phillips, in a masterly analysis, demonstrates and supports this position and then explains how the system as a whole succeeds in doing what the individual banks of the system cannot do, namely, expand loans and deposits in a multiple of additional reserve money received.

The theory that a single bank can expand loans to a multiple of additional reserve money received is apparently based on the assumptions, first, that the borrower will leave the proceeds of his loan on deposit at the bank and, second, that he will either not draw upon these deposits, or if he does, that amounts roughly equal to the sums so drawn will be received by the bank from other sources. The first assumption is justified; the second is open to question.

If a bank receives new cash to the amount of $50,000 and then proceeds to lend to borrowers $500,000, the immediate result will be an

RESOURCES AND LIABILITIES OF ALL REPORTING BANKS IN THE UNITED STATES AND POSSESSIONS, JUNE 30, 1928 (26,213 BANKS)

(In Thousands of Dollars)

Resources	
Loans and Discounts, including Rediscounts	$39,542,067
Overdrafts	50,407
Investments, including Premiums on Bonds	18,771,814
Banking House, Furniture and Fixtures	1,663,696
Other Real Estate Owned	403,967
Due from Banks	3,616,408
Lawful Reserve with Federal Reserve Banks or Other Reserve Agents	3,105,840
Checks and Other Cash Items	854,531
Exchanges for Clearing House	898,567
Cash on Hand	887,845
Other Resources	1,779,186
Total Resources	$71,574,328
Liabilities	
Capital Stock Paid In	$3,525,522
Surplus	4,145,529
Undivided Profits, Less Expenses and Taxes Paid	1,226,361
Reserved for Taxes, Interest, etc., Accrued	83,753
National Bank Circulation	649,095
Due to Banks	4,081,028
Certified Checks and Cashiers' Checks Outstanding	807,580
Dividend Checks Outstanding	57,005
Individual Deposits, including Postal Savings	53,244,698
United States Deposits	222,816
Notes and Bills Rediscounted	319,317
Bills Payable, including All Obligations representing Money Borrowed Other than Rediscounts	1,246,829
Other Liabilities	1,964,795
Total Liabilities	$71,574,328

increase of deposits of approximately $500,000 against which the $50,000 new cash is the proper legal reserve. But it is a fair assumption that borrowers to the extent of $500,000 make their loans for specific purposes. Generally, they borrow money in order that they may use it and that use will shortly be indicated by the borrowers' drawing checks against their accounts for a very substantial part of the amounts borrowed. These checks will be mailed to or delivered to creditors of the borrowers and in a few days will return to the banking system for

collection. If they are deposited in banks other than the bank making the loans, that bank will have to honor these checks and will experience unfavorable clearing-house balances in amounts greatly in excess of the $50,000 reserve which was the basis of the entire series of transactions.

The conditions under which this unfavorable clearing-house balance would not be experienced are, first, that the loaning bank was the sole bank of the community within which the transactions occurred, or, second, that the other banks of the community were expanding their loans and deposits to an equal degree. In the first instance, that of a bank having monopoly of the banking activities of a given community, the checks drawn by the borrowers of the $500,000 would be returned to the bank as deposits by the creditors of the borrower who were recipients of the checks. No loss of cash would result to the bank, as changes in deposit accounts would be accomplished by alterations of bookkeeping items alone. But there are comparatively few banks in the United States which have this monopolistic situation. It is true that there are numerous small country localities where there is only one bank, but even in these instances a large proportion of the business done by that bank's borrowers would be done with out-of-town business houses, so that the individual bank attempting to expand its loans in the manner suggested would lose funds to out-of-town institutions which received the checks drawn by the borrower.

In the cities where there are numerous banks, it will be inevitable that a considerable proportion of the checks drawn will be deposited with other banking institutions, although some few of the checks drawn may be redeposited with the lending bank by depositors who happen to be creditors of the borrower. If the other banks of the community were also recipients of new reserve money, in sums approximating the $50,000 of the bank in question, and also had loaned $500,000 to customers, then there would be an equal chance that the checks drawn against the deposits arising out of these various loans would have a relatively equal distribution among the banks of the community and result in a very small net loss of cash to any one of them. But this rate of expansion of all the banks at the same time cannot be anticipated and is extremely unlikely, as it far surpasses the average rate of growth of both the business communities as a whole and the banks therein.

What actually occurs is this. Bank A in a given community receiving a new cash addition to its reserves in the amount of $50,000 can lend a sum approximately equal to that, or perhaps a little more. The borrower will draw against the deposits so created. The bulk of the

checks so drawn will be deposited in other banks, and Bank A must honor them by settling unfavorable clearing-house balances in favor of these other banks. There will result to Bank A a loss of cash, and the amount of cash not so lost by remaining with the bank will, after the loss has occurred, bear to the loans the ratio of approximately 10 : 1, or whatever other ratio is customary to that bank or that community. In other words, if a bank receives $50,000 of new reserves it does not establish the 10 : 1 ratio by lending $500,000, but establishes it by lending $50,000 and then losing $45,000 of cash.

This $45,000 of cash so lost, however, becomes new money in the possession of the other banking houses which, in turn, can lend an amount approximately equal to their new receipts, will lose a considerable proportion of that cash as a result of the loans, which in turn in the possession of the new banks receiving it becomes the basis for loans, so that by the time $50,000 has become distributed through the banks in the community it has served over and over again as a basis for loans which establishes the multiple ratio for the system as a whole.

The conditions which will determine the amount which individual banks can lend as a result of the receipt of new cash will vary with the location of the bank, the character of its customers, and the business and banking conditions of the community. If there are few banks in the community, a larger proportion of checks so drawn as a result of new loans will be received as deposits by the bank making the loans, which will enable it to lend a larger amount than would be possible if these conditions did not exist. A bank can lend more if its customers leave a larger proportion of their loans on deposit during the life of the loan, either resulting from rules of the bank to that effect or from the business habits of those customers. For example, a bank may require its borrowers to maintain during the life of their loans a deposit balance equal to 20 per cent of the sums borrowed. In that case, the bank will lose less cash than if no such requirement were made, or if their borrowers were accustomed to utilizing at once practically the entire sum borrowed.

This explains why it is more profitable to a bank to lend its funds over and over again on short-term loans which are paid at maturity rather than lend the same sum for a long period of time at the same rate of interest. It might, on the face of it, appear to be a matter of indifference to a bank whether it loaned $100,000 at 6 per cent for a year, or $100,000 at 6 per cent twelve times over during the year for 1 month each time. In either case it would seem that the total gross receipt would be $6,000 per year. The fact is, however, that the bank

would be in a position to lend more money to others in the case of short loans frequently repaid than in the case of the year loan; for the average balance maintained by the borrowers would be greater in the former case than in the latter. When a loan is made, it takes several days for the checks to go the rounds from depositors to creditors, back to the banks and through the clearing houses, and during that period the banks have lost no money as a result of the loans, but receive interest on the loans made. This would occur twelve times a year instead of once, in the case of the frequent lending of the $100,000. Again, in order to pay the loan off, the borrowers generally accumulate sums on deposit for some days prior to the maturity of the loan, so that it can be canceled at maturity by a check on the bank. The accumulation of funds to the obvious benefit of the bank would occur twelve times a year in the case of the frequent short-term loans, instead of once, if but one loan had been made.

That a bank cannot lend many times the amount of new reserve money received becomes obvious when the theory of the Federal Reserve discount rate is considered. It is assumed, and the assumption is generally admitted to be correct, that a slight increase in the discount rate will have the tendency to discourage banks from borrowing from the Federal Reserve System. This tendency would certainly not be observable if the banks could lend a multiple of the sums so borrowed. If a bank could borrow $50,000 from the Federal Reserve System and then proceed to lend $500,000 at 6 per cent, the change of 1 or 2 per cent in the discount rate would be a matter of comparative indifference to the bank. It could afford to pay the Federal Reserve bank 30 per cent for the money and yet make a substantial profit, whereas it is a matter of common observation that an increase of even 1 per cent in the discount rate will tend to discourage a certain amount of bank borrowing. The fact is, of course, that if a bank borrows $50,000 from the Federal Reserve it can only lend approximately that amount, and, consequently, an increase in the reserve rate makes a material change in the profit of the transaction.

For a thorough discussion of this principle the reader is referred to Mr. Phillips' volume, "Bank Credit."

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CHAPTER X

GUARANTY OF BANK DEPOSITS

It has been stated previously that two forms of bank credit are used as a medium of exchange, namely, bank notes, of which an example is the national bank note issued by the national banks of this country, and deposits utilized by means of checks.

Universal agreement exists throughout the civilized world concerning the need for protecting the holders of bank notes by requiring the banks of issue to keep definite and valuable security behind the notes, or by an actual or implied guaranty on the part of the government to make the notes good in case of failure of the banks. In practically all countries, government statutes require a specific security as well as reserve to be kept against currency issued by the note-issuing institutions. In this country, the National Bank Act, as amended by the Federal Reserve Act, requires specific security and reserves to be kept against national bank notes, Federal Reserve notes, etc. Thus, for example, the security behind the Federal Reserve note must consist of gold and commercial paper or member banks' notes secured by eligible paper or government securities equal in value to the amount of the issue, and a reserve of 40 per cent of gold must be maintained. The gold reserve can be counted as part of the security. In addition, the notes are obligations of the United States government and as such their payment is guaranteed. The national bank notes must be secured by government bonds to the extent of 100 per cent, plus a 5 per cent gold redemption-fund reserve. Therefore, it might be stated that universal agreement exists as to the need for protecting the holders of notes issued by banking institutions.

This is not true of the second form of bank credit, namely, bank deposits. There are practically no foreign countries which legally require certain and specific reserves to be kept against deposits. It is otherwise in the United States, where both state and national laws specify the exact reserve which must be kept against deposits. Thus, for example, in Pennsylvania the state institutions must keep a reserve of 15 per cent against *immediate demand liabilities* and a reserve of 7½ per cent against time deposits if they are not members of the Fed-

eral Reserve System, while the National Bank Act, as amended by the Federal Reserve Act, states that national banks must keep a reserve of either 13, 10, or 7 per cent against demand deposits, depending upon the location of the national bank, and 3 per cent against time deposits in all cases. The reserves of national banks, it will be recalled, must be kept in the vaults of the Federal Reserve banks of the respective districts, and the Federal Reserve banks in turn are required by law to keep a reserve of at least 35 per cent, consisting of gold and lawful money, against deposits made by member banks. In no instance is a security required against deposit liabilities in addition to the reserve requirements.[1]

Many people, however, felt that the banks of this country should go further in safeguarding the depositors, and as early as 1829 the state of New York enacted a law which was aimed to guarantee all the debts of banks located therein, which of course included deposits of the banks. This system was called the *Safety Fund System*, and the banks were assessed the sums necessary to maintain the guaranty fund. The heavy losses incurred thereby, because of inefficient and dishonestly managed institutions, and as a result of the panic of 1837, caused the early repeal of many sections of the act establishing this system, to that finally only the notes of the issuing institutions were protected by the *safety fund*.

It is unlikely that the *safety fund* experiment of New York had much influence on the guaranty laws that came into existence 75 years later, incited mainly by the heavy losses sustained by depositors of banks as a result of the panic of 1907. Oklahoma passed a law guaranteeing bank deposits on Dec. 17, 1907; Kansas, Mar. 6, 1909; Nebraska, Mar. 23, 1909; Texas, Aug. 8, 1909; Mississippi, Mar. 9, 1914; South Dakota, Mar. 13, 1915; North Dakota, Mar. 10, 1917; and Washington, Mar. 10, 1917. For some years the Comptroller of the Currency recommended such laws for the National Banking System, but without effect, and as recently as 1928 there was agitation in the state of Iowa to pass legislation to that end.

The Oklahoma Law.—The Oklahoma law may be used as an illustration of the methods utilized in attempting to guarantee the repayment of all the deposits placed in banking institutions. This law went into operation Feb. 14, 1908, and made it compulsory for all state banks, as well as the banking departments of trust companies,

[1] Government deposits are secured by certain specified bond reserves amounting to 100 per cent of the deposits. It is unnecessary to keep legal reserves against these deposits.

to participate therein. The law guaranteed deposits of failed banks but not deposits otherwise secured, nor any deposits on which a greater rate of interest was allowed than permitted by the rule of the bank commissioner.

Under its original terms the law provided for the creation of a fund to pay depositors of failed banks, by levying an assessment against each state bank and trust company equal to 1 per cent of its average daily deposits. Should the fund be exhausted, it could be replaced by means of special assessments unlimited in amount. The danger to the banks involved in this possibility of unlimited assessment led to modifications in the law, and by amendment it was provided that annual assessment should be made equal to one-half of 1 per cent of the annual deposits, and no more. During the years 1914, 1915, and 1916, however, the state banking board was permitted to levy annually an extra assessment of one-fourth of 1 per cent, though such extra assessments were prohibited after the year 1916. If in any year the fund was depleted, the state banking board was authorized to issue to depositors of failed banks certificates of indebtedness bearing interest at the rate of 6 per cent per annum. These certificates were to be paid off and retired when the annual assessments brought in sufficient funds.

Of the fund, 75 per cent was to be invested in certain designated types of securities and the balance was to be held by the banking board as a ready fund.

By a later amendment it was provided that the guaranty fund was to be paid to the banking board in cashier's checks which were not collected until the board deemed it necessary to do so. This gave to the banks for the time being the use of their own assessment. To secure this liability to the fund each bank was required to deposit with the banking board certain specified securities in an amount equal to one per cent of its average daily deposits, and in no case a total of less than $500 of such securities could be deposited by any one bank.

A state board was appointed to supervise and control the guaranty fund and to take charge of the affairs of insolvent banks.

The Operation of the Law.—During the first 12 years of the operation of the law 57 bank failures occurred, and the fund was depleted after the first few failures. The average rate of assessment from 1908 to 1920 was 3 per cent of the capital stock of the banks; or for the entire period the banks were assessed an amount equal to 36 per cent of their capital stock. This assessment was, of course, in the most part passed onto the public in the form of higher interest rates because the banks had to recoup their losses.

The guaranty fund became inoperative in the fall of 1921, and a condition characterized as one of practical insolvency developed, and was present from that time until Mar. 31, 1923, when the act was formally repealed. It can therefore be stated that the experience of Oklahoma, so far as the guaranty law was concerned, was most unfortunate. As one banker put it, the well-managed institutions were penalized, while wildcat banking was encouraged. Some of the banks in this state placed in conspicuous parts of their buildings signs to the effect that deposits were guaranteed by the state, and then by offering large interest rates attempted to induce depositors to place their funds in the institutions. These so-called bankers in turn would utilize the funds thus secured in making reckless loans. The conservatively managed institutions would have to stand by because they could not afford to pay depositors a higher rate of interest, nor could they extend credit recklessly as their unscrupulous competitors did.

An interesting situation in respect to the organization of state or national banks tended to develop as a result of the state guaranty laws. When the laws were first passed, it appeared that depositors in state banks had a higher degree of safety than depositors in national banks, as the state guaranty laws did not apply to the national institutions. In consequence, some of the national banks hastened to convert their banks to state institutions in order to keep their depositors. When it soon developed, however, that the assessments for the maintenance of the guaranty fund seriously impaired the profits of the state banks, and that depositors of failed banks experienced long delay in reimbursement for their losses due to the rapid depletion of the guaranty fund, the pendulum swung in the other direction and many state banks hastened to surrender their state charters and join the national system.

Arguments in Favor of Deposit-guaranty Laws.—The arguments which have been advanced in favor of laws guaranteeing bank deposits are as follows:

1. Bank deposits as a medium of exchange have to a large degree replaced bank notes and other forms of currency. It is estimated that over 90 per cent of the business of the United States is carried on by means of checks against deposit accounts, and it is argued that it is at least as necessary to protect the holders of these checks as it is to protect note holders.

2. Such laws would prevent the general distress that follows bank failures. The losses suffered by state and national bank depositors, particularly in certain localities, have been substantial, especially in

recent years. The Comptroller reports losses resulting from the failure of national banks since 1863, in excess of $69,000,000, and the losses of state bank depositors must be considerably greater than that sum because state banks outnumber national banks more than two to one, and, in general, their supervision is less efficient. It would probably be safe to estimate the total losses of depositors at not less than $3,000,000 a year. This is not only a fairly imposing figure in itself, but becomes more serious when it is considered that the losses tend to become concentrated during periods of depression when the community is least able to suffer it. One effect of deposit guaranty would be to spread this loss more equally over longer periods of time.

3. Panics may be prevented by assuring depositors of the safety of their funds. The original impetus for the passage of the guaranty laws was the panic of 1907, attended by numerous bank runs, with resulting bank failures. These runs are caused by fear on the part of depositors that their deposits are in jeopardy, and many banks otherwise solvent failed because of their inability to withstand the runs, which would not have occurred had the depositors been assured by a guaranty law that their deposits would be repaid.

4. A considerable section of the public lacks the necessary confidence in banks to utilize them for deposits, and in consequence hoarding of money occurs on a large scale. Deposit-guaranty laws would create the necessary confidence, and hoarding would decrease, the public would make a larger use of banks, additional funds would get into circulation, and both the business world and the public would thereby substantially benefit.

5. If all banks are compelled to contribute toward a fund to meet bank losses, the bankers would have an immediate and compelling motive to improve banking conditions. Bank supervision would become more effective and the reckless bankers would be forced out of business. Self-interest would bring about improvement of banking methods.

Arguments against Deposit-guaranty Laws.—The arguments which may be advanced against laws guaranteeing deposits are:

1. Admitting the relative importance of bank deposits as a medium of exchange in comparison with notes, it does not thereby follow that their ultimate payment should be guaranteed. Bank notes are accepted freely by any one; they pass from hand to hand without consideration of the credit standing of the parties to the transaction. This is necessary in small retail transactions where notes are used. Checks, on the other hand, are used to settle obligations between people who have business

relations and who are known to each other, or concerning whom credit information can be discovered. Checks are not often used to settle transactions between strangers.

It is not accurate to state that there is no security back of deposits. In addition to the legal reserve required, there is a substantial guaranty fund in the form of capital, surplus, undivided profits, and the double-liability feature of capital stock. It is true that this fund is not specifically allocated to deposits; it is equally applicable to all of the liabilities of the bank, but deposits are in all cases the major liability of a bank; the other liabilities are relatively unimportant.

2. Guaranty laws are unnecessary, because the actual losses to bank depositors through bank failures are slight. Taking the national banking system, for which alone accurate figures can be given, the average annual loss to depositors since 1863 has been only one twentieth of 1 per cent of deposits. Even admitting that the losses in respect to state banking systems have been somewhat higher, the percentage would still be surprisingly small.

3. Guaranty laws will not prevent panics. There is no unanimity among economists as to the cause of panics, but it is certain that they result from unsound conditions of the banking and business world. Runs against banks are only symptoms and not causes of panics. They draw public attention in a spectacular manner to the conditions which make them possible, but the causes of those conditions lie deeper in the economic and perhaps psychologic make-up of society. To eliminate runs against banks would not prevent panics but only alleviate one of their results. Furthermore, it is unlikely that guaranty laws would make runs against banks impossible, for depositors would always fear a possible insolvency of the guaranty fund, or, at any rate, long delay in reimbursement.

4. Guaranty laws would have little effect upon hoarded money. In the first place, the amount of hoarded money is probably greatly exaggerated, and, second, the government has provided, for those who are fearful of the ordinary banks, a secure depositary for funds, in the Postal Savings System.

5. The argument concerning the change of banks from the state to the national system, or the reverse, has already been developed, and may be considered an argument against guaranty laws, unless they can be made uniform in application to both state and national banks.

6. Deposit-guaranty laws will not tend to create sound banking practice. It will take away one deterrent to reckless banking, the fear of losses to depositors. Very few bankers, however incompetent, over-

look entirely the interests of the depositors, and the possibility of loss to them acts as a restraining influence. This would be removed if the state guaranteed the repayment of deposits in full.

7. Deposit-guaranty laws are expensive. They add, to the ordinary costs of banking, the costs of a state-managed department or bureau for the administration of the guaranty fund. The burden of these costs as well as the cost of reimbursing the depositors of failed banks falls upon the better banks of the community, which are taxed to pay the losses resulting from the practices of unsound banks. In a sense it is placing a premium on reckless banking. These banks have everything to win and less to lose than formerly.

8. It will stimulate unsound banking practices from another point of view. It will take away from depositors the incentive of making a wise selection of a bank. Today, in the competition for deposits, banks endeavor to gain the confidence of the public in their safety and wise management. If all are made equally safe by government action, that motive is removed.

9. The public must ultimately pay the cost of the system, for banks will reimburse themselves for the direct expense by exacting higher interest rates or paying a smaller interest on deposits. This will tend to react unfavorably upon business activities.

These acts are frequently referred to as insurance acts, based upon principles similar to those which have created insurance in other lines of activities. In truth, however, the guaranty fund is not an application of sound insurance principles, because insurance companies do not charge the same rate of premium on all risks. Life insurance premiums vary with the age or health of the individual; fire insurance premiums vary according to the character, condition, and location of buildings, etc. Under the guaranty fund, all banks, good and bad, are taxed on the same basis. If insurance companies in general would apply this method to all individuals and to all buildings, it would mean that the insurance companies would soon be forced into insolvency. In other words, insurance principles dictate that the element of risk must be guarded against, and this is done by differential rates, depending upon the circumstances surrounding each particular case.

Depositors of a bank, or of banks, can only feel assured of the safety of their deposits when they are certain of the integrity and ability of the administrators of the institutions. Not even by the widest stretch of the imagination can it be stated that a guaranty fund induces greater integrity or ability so far as the banking community is con-

cerned, and there is every reason to believe, at least judging from the experience of those states in which the law was tried, that the opposite will result, and that unsound banking practices will grow under such a law.

While it is important that the depositor of the bank be safeguarded in every way possible, because it is true that he is the innocent party in case of a bank failure, nevertheless the method by which he is to be guarded must be a sound method which actually will accomplish the purpose for which it was created. Perhaps the development of sound banking practice, or the extension of state powers of supervision over banking, and the raising of the standards of banking by a higher type of legislation might provide adequate protection for depositors of failed institutions, because, generally speaking, it can be stated that banks fail because of poor management or dishonesty. Poor management can be overcome to some extent by raising the banking standards of a state through the revision of the state banking laws, placing them on a higher plane. Dishonesty can be overcome to some extent by strict supervision of the banking activities of a community through a well-established corps of examiners operating under the jurisdiction of a highly efficient state banking department.

It appears from the experiences of those states which have tried the guaranty fund that such a fund does not meet the purpose for which it was created, but on the contrary brings into existence even greater evils, and today state guaranty laws are practically out of operation.

The present status of state guaranty laws is as follows:

Oklahoma	Law repealed, Mar. 31, 1923
Kansas	Law repealed, Mar. 14, 1929
Nebraska	Law not repealed, but inoperative
Texas	Law repealed, Feb. 11, 1927
Mississippi	Law not repealed, but inoperative
South Dakota	Law not repealed, but modified
North Dakota	Law not repealed, but inoperative
Washington	Law repealed, June 11, 1929.

The experiences of South Dakota and Texas are typical of the condition in other states.

In South Dakota from Feb. 1, 1916, to June 1, 1926, the receipts of the fund amounted to $3,167,473 in the form of assessments and $221,547 recovered from the liquidation of the assets of failed banks. Out of this, $3,068,200 was used to pay depositors of failed banks, leaving a balance of $320,820. Adding to this the 1926 assessments of $265,097, there was a balance at the end of 1926 of $586,727.

Against this balance there were outstanding liabilities of approximately \$50,000,000 with an annual increase amounting to about \$2,500,000. Since Mar. 1, 1923, payments have been made only on a percentage basis, due to the large numbers of bank failures.

In Texas, between Jan. 1, 1917, and Jan. 1, 1926, 150 guaranty-fund banks failed, costing the fund approximately \$17,000,000. During the period of most numerous failures, the assessments against the banks reached 2 per cent of the average deposits, necessitating the passing of dividends by many sound banks, and resulting in general dissatisfaction.

Responding to the demand for relief, the legislature amended the law in 1925, allowing the banks to choose between contributing to the guaranty fund, or furnishing a personal or surety bond the size of the bank's capital stock. All but 24 of the banks went under the bond plan. Subsequently, some of the remaining guaranty-fund banks failed, the rest were too weak to contribute, and the plan died a natural death even before it was repealed.

One writer has summarized the reasons for the failure of the Texas law as follows:

1. The plan made too many banks and too few bankers. All kinds of incapable people tried to start a bank under the protection of the fund.
2. The system did not increase deposits nor build up the banks. Instead, it gave a sense of false security—people looked to the fund for protection and paid no attention to the soundness of the banks themselves, nor to the ability of their managers.
3. Prosecution of bank wreckers and crooks was made impossible. The depositors got their money from the fund, so they were not particularly interested in prosecuting the unscrupulous or incompetent men who caused the banks to fail.
4. Such an unsound system of banking weakened the financial structure of the entire state.[1]

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CHAPTER XI

TELLERS

The daily cash transactions of a bank with the public are carried on by means of *tellers*, divided in most banks into three classes—paying, receiving, and note tellers. The tellers act under the general supervision of the cashier.

Paying Teller.—The paying teller is generally known as the *first* teller, so called primarily because of the great responsibility of his position. His primary duty is to take charge of the cash of the bank and pay it out over his counter. He may be assisted by one or more assistant paying tellers, depending upon the size of the bank and the quantity of its business. His duties cover a wider or narrower field, depending upon the relative size and departmentalization of the bank. For example, in some banks the paying teller also certifies checks and other items, cares for the signature files, etc., while in some large institutions there is a separate certification department and separate clerks are in charge of the signature files.

In a bank of moderate size, the paying teller's duties may be described as follows: Prior to the opening of the bank for business, the paying teller determines the amount of cash to be taken from the vault to his cage. He is guided in his judgment of the amount required by his experience of the probable cash demands upon the bank. For example, he takes cognizance of the pay days of the corporations of the community which are customers of the bank, and the probable larger demand for cash for week-end or holiday purposes. On Friday afternoon many merchants, anticipating a Saturday-morning rush, provide themselves with coin and currency for change. Numbers of corporations pay their employees by check on Friday, and on Saturday morning the employees, or their wives, come to the bank to have their checks cashed. Customers going away over the week-end get checks cashed, the merchants doing business on Saturday afternoon and evening, or Sunday morning, provide themselves with adequate change, as they can have no recourse to the banks during those periods.

Having decided upon the amount probably necessary for the day,

the paying teller arranges the money he takes to his cage so that it can be conveniently handled. The metallic coins are put into separate compartments of the drawer or, nowadays, into machines operated mechanically so that the depression of certain keys will release specified sums. The paper money is generally put up in bundles with a paper strap gummed on one end. The different denominations may be bundled as follows: ones and twos in bundles of $50; fives, in $250; tens, $250 and $500; twenties, $500; fifties, $500. Many banks use a distinctive colored strap for each denomination. These bundles are also placed in separate drawer compartments, so that they may be conveniently and rapidly paid out.

It is the duty of the paying teller to see that there is a sufficient supply of cash in the bank to meet all normal requirements. The cash in excess of that kept in the cages is in the vault, generally under dual control requiring an officer as well as another employee to gain access to it. When the supply of certain denominations must be replenished, the paying teller notifies the cashier who obtains the necessary currency, generally from the Federal Reserve bank of the district. For out-of-town banks the paper money is sent by mail or express, and the coin generally by express in canvas bags. Each shipment is accompanied by notification by mail and an acknowledgment slip for receipt when the currency is received. Banks located in a Federal Reserve city may obtain currency from the Federal Reserve bank by messenger.

All monies received by the receiving teller are turned over to the paying teller, who receipts therefor. A portion of the paper money received is generally old or mutilated, and such mutilated money is separated by the paying teller, wrapped, and returned to the Federal Reserve bank. All shipments of currency are, of course, insured; the insurance is placed by the Federal Reserve bank upon advice from the banks making or receiving the shipment. The express or postage costs of shipment are borne by the Federal Reserve bank, which reimburses the banks making the original outlay. In addition to mutilated currency, banks send or deliver to the Federal Reserve bank surplus currency which they may receive in excess of their needs. Occasionally, such excess currency is not sent to the Federal Reserve bank but is delivered to other banks of the community requiring currency, upon receipt of their drafts for the amount delivered on some reserve city bank.

During the course of a day's business the paying teller pays a number of different items such as: (1) checks on customers' accounts and, on other banks, (2) notes, (3) money orders, (4) travelers' checks, (5) coupons, (6) liberty bonds. The great majority of paying operations are

on checks and in respect to these the paying teller must be constantly on the alert.

He must be accurate and speedy in the counting and paying out of money. The paying out by mistake of a sum in excess of a check presented is one of the most difficult errors to rectify. Unless the recipient of the money reports the error and returns the surplus payment, it is extremely difficult to check. If the shortage for the day is such a sum as an even $100, it may be that an extra $100 bill has been paid out in error. The payment of $100 bills is not extremely common, and perhaps under those circumstances the paying teller can recall the individuals to whom he made payments of $100 and questioning them may result in a discovery of the individual to whom it was paid. If the error is in small or odd amounts, it is practically impossible to trace, and is under those circumstances charged off against a bank's operations as a loss.

The paying teller must be familiar with the names and faces of the customers of the bank who cash checks, for the bank is responsible for paying checks to the wrong person. Customers who have done business with the bank before never like to be called upon to identify themselves and in consequence the paying teller must familiarize himself rapidly with the faces of the bank's customers. If a stranger comes in and presents a check to be cashed, the paying teller should properly refer that individual to an officer of the bank who will take such steps as he deems necessary to identify the presenter. If the officer authorizes the paying teller to cash the check, the teller is, of course, relieved of any further responsibility.

The paying teller must be somewhat of a handwriting expert. He should be generally familiar with the signatures of the customers of the bank, although he has at his disposal the file of signature cards to which he can make reference if he is in doubt as to the genuineness of any signature. He is of particular value to the bank if in making such a comparison he can recognize a clever forgery. He must rapidly examine each check presented to see that it is drawn properly as to form, that there is no variance between the written and numerical amount of the check, and that it is dated either on or before the day presented. A bank has no right to pay a post-dated check, and for such a payment the bank will be responsible if loss results to the drawer.

Banks are responsible for paying forged checks, but their responsibility differs if the forgery is of a signature or if the forgery consists of raising or altering the check in some other respect. If a bank pays a check on which the drawer's signature has been forged, the bank cannot

recover the amount paid from an innocent holder of the check for value, nor can it charge the drawer's account with the amount of the check because it is bound to know its depositors' signatures. But, if a bank pay a check upon which the signature is valid, but the amount has been raised, it can recover the excess amount so paid from the one who received it, even though that individual may be an innocent holder for value. The bank, however, cannot in any case charge the depositor's account with the amount of the raised check, but only with the amount of the original check before it was raised. If the payment resulted from negligence on the part of the teller, it has been held that the bank can recover from its own teller if it chooses to hold him responsible. The negligence, however, must be gross. That is, there must have been something to put the teller on information that there was probably some irregularity in the check.

Under Sec. 124 of the Negotiable Instruments Act, the maker is liable to the holder in due course for the original amount of the check. Where the amount has been altered or the payee's name changed, the bank which pays such check is considered to have paid it under mistake of fact and can collect the amount so paid from the recipient or if the amount has been changed, the excess amount. However, if the alteration was made possible by the drawer's negligence, the bank which pays the check is not responsible to the drawer. For example, in one case the drawer drew a check for $11.85, leaving the line for the written amount blank. The payee changed the figures to $871.85 in a way not discernible except under magnifying glass, and filled in the written part of the check for that amount. In this, the court held that the negligence of the drawer prevented the recovery from the bank which paid the higher amount. However, drawers are required only to draw their checks with reasonable care and are not required to use any of the instruments now marketed for stamping or perforating checks with the amount to be paid. The proper method of drawing a check is to fill in both the written and the numerical amount, to start the writing and the number as far to the left as possible, and to fill in at the right the space remaining with an inked line. If those precautions are adopted, the responsibility is clearly placed upon the bank for the payment of an altered or raised check. Most jurisdictions hold that indorsers are not liable for any alterations made subsequent to their indorsement. It has been held by some jurisdictions that the drawing of a check in lead pencil will not constitute negligence by the drawer, although there are some decisions to the contrary. Most banks, however, make it a rule not to pay checks drawn in lead pencil and this is

entirely proper, and the rule will be recognized as valid by the courts if the depositor has had notice of it. Certainly, everything should be done to discourage the drawing of checks in lead pencil.

Where the alterations consist of scratching out the name of one bank and inserting the name of another, it has been held that such alterations are legal but it is certainly dangerous for the bank to pay such a check without satisfying itself that the change in the name of the bank was authorized. Alterations made by the drawer himself do not invalidate the check, but banks should satisfy themselves that the alterations are done by the drawer and until they have so satisfied themselves it is proper for them to refuse to honor the check.

The payee has no authorization to alter a check in any respect even those parts of the check which are not necessary to its validity as a negotiable instrument. For example, a check is drawn and upon it the drawer writes *in full of account to date.* If the payee erases this statement, or alters it in some material way, as for example: *in full of account to Mar. 31, 1921*, the bank should refuse to honor the check; although there is some legal doubt as to whether the bank would be liable for monetary damages to the drawer if the check was paid under those circumstances. A safe rule for the bank to follow is to pay no check which is altered in any respect without inquiry or authorization by the drawer. The alteration of the date of a check by any person other than the maker is a material alteration to which the above rule should also apply.

Tellers must not only ascertain whether or not the date has been altered by some one other than the maker, but must also make sure that the check is not a *stale* check. This term is given to those checks which have been drawn a considerable period of time prior to presentation. From a legal point of view a check is a valid order on a bank when presented, irrespective of the time period which has elapsed from the date of making to the date of presentation, unless that period has exceeded the statutory limit fixed by the laws of the state in which the bank is located. However, as a matter of practice, banks are justified in questioning the validity of *stale* checks. The best procedure for the teller to adopt is to get in touch with the maker of the check and ask him whether or not the check is still to be honored; or, failing that, to take the matter up with an officer and leave the decision to him.

Stop Payment Orders.—In the case of the loss or theft of a check or where a check has been drawn or delivered in error, the drawer may order the bank not to honor the check when presented. This is

technically known as *stop payment.* The proper method to stop the payment of a check is to send in writing to the bank an order not to pay or honor check number —— to the order of ——— in ——— amount, dated ———. If the check has not already been paid, the responsibility for paying the check after such a notice has been presented to the bank lies with the bank, and it is liable in damages to the drawer for honoring a check after notice of *stop payment.* All notices of *stop payment* will be kept by the teller at a convenient place at his desk so that constant reference can be made to them in case of the presentation of checks covered by the *stop payment* notices.

It is also possible to give *stop payment* notices to the bank orally, or over the telephone, and it is advisable to do this, once the loss or mistake has been discovered, the oral notice to be followed by a written memorandum verifying it.

It has already been stated that if a bank chooses to honor a check after or before its customary banking hours it is its privilege to do so, and the receipt of a *stop payment* order after the check has been honored, even though the order was received in time to have prevented payment of the check if the bank had confined its payments to its regular banking hours does not impose liability upon the bank. This, however, is only true in the absence of statutory regulation strictly fixing the business hours within which banks may transact business. Under those circumstances a strict interpretation of the statutes might impose liability upon the bank. The decision might also be different if the bank cashes the check on Saturday afternoon or evening, because Saturday is a half holiday under the laws of most states, and the Negotiable Instruments Act says (Sec. 85):

> . . . instruments falling due or becoming payable on Saturday are to be presented for payment on the next succeeding business day, except that instruments payable on demand may, at the option of the holder, be presented for payment before twelve o'clock on Saturday when that entire day is not a holiday.

It would seem, therefore, that the bank would be taking unnecessary risk in paying a check on Saturday afternoon or evening, or on any holiday, except, of course, to the depositor himself.

The teller must see that the checks presented are properly indorsed. If the check is drawn or indorsed to the order of the individual cashing it, he must indorse it in order to transfer the title to the bank. Even though the checks are drawn or indorsed in such a way as to be payable to bearer, and title passes by delivery only, nevertheless the bank

properly requires, even in such cases, an indorsement by the presenter, which serves two purposes: first, it indicates to the bank the person to whom the money was paid, and second, that indorsement constitutes a guaranty of the validity of the check so that in case of non-payment, the bank can recover the amount paid from the person receiving the money. This risk, of course, is an insignificant one, if the check being cashed is a check on the bank. Banks, however, frequently cash, for their customers, checks which are drawn on other banks, and the bank has no way of ascertaining at the moment whether or not the check is valid and will be honored by the bank upon which it is drawn.

Finally, paying tellers must be certain that there is a sufficient balance in the bank to cover the check, assuming that the check is on the bank to which it is presented. If the teller is in any doubt as to the drawer's balance, he can ascertain the amount of the balance from the bookkeepers. For customers that are well known, overdrafts in small amounts are occasionally permitted and the question of the satisfactory amount of the balance may not be raised.

Banks have occasionally suffered losses through ingenious rogueries in respect to honoring checks in excess of the drawer's balance. It is related that a depositor having a substantial balance went into a large bank to one of the teller's windows and stated that he wished to close out his balance, and withdraw the amount of money standing to his credit. The teller communicated with the bookkeepers, who reported the amount standing to the credit of that customer. The customer drew a check to the order of cash for that amount and received the money. He then walked to another teller's window and made the same statement. That teller communicated with the bookkeepers, and found that the balance was still as previously stated, because, of course, the preceding transaction at the other teller's window had not as yet been sent to the bookkeeping department. The depositor then drew another check to cash, drew out the same amount, walked out of the doors and was known no more to the bank. This kind of fraud would be difficult if the tellers' windows were divided alphabetically so that the same teller always dealt with the same group of depositors.

When checks on other banks are presented, the teller cannot be satisfied as to all of the particulars above enumerated. In such case these checks are cashed only for (*a*) customers; (*b*) persons identified by customers, in which case the customer is ordinarily required to indorse the check; and (*c*), persons well known to one or more of the officers of the bank. Tellers are presented with a trying problem when strangers present checks. It would, of course, be a very simple matter to refuse

to honor the check, but these individuals may be prospective customers of the bank, and such treatment may well alienate them and have a detrimental effect upon the bank's future business. The teller or the officer should make every reasonable effort to identify the presenter and explain to him with considerable tact the reasons why the check is not honored, if that is the ultimate decision. A proper amount of courtesy under those circumstances may at the same time protect the interests of the bank and not lose a possible customer.

Although the problem of counterfeit money is one which chiefly affects the receiving teller, nevertheless some counterfeit currency may have by accident slipped past the receiving teller and appear at the paying teller's desk. He should, of course, be careful not to pay out such counterfeit money. The *National Counterfeit Detector* is a publication issued to banks to keep them posted on counterfeit money in circulation.

Paying tellers occasionally have to make up payrolls for business depositors in accordance with the payroll lists and amounts furnished by the customer.

The checks and other items cashed passing through the paying teller's cage are listed and added before leaving the cage. Checks on customers' accounts are given to the bookkeepers, foreign or out-of-town checks are given to the transit department, and local items are taken by the domestic clearing department. During the course of the day the paying teller receives cash from other departments of the bank. This cash coming into other departments may be derived from: (1) deposits, (2) cash payments on notes, (3) returned items taken up, (4) sight drafts paid, (5) acceptances paid, (6) box rents paid, (7) foreign exchange sold, (8) travelers' checks sold, (9) bank drafts sold.

The records of payments to the paying teller's cage are made by him and receipts are given to the department from which the cash is received. The paying teller keeps a daily proof sheet on which he charges himself with the foregoing receipts, with the receiving teller's cash from the previous day, and receipts from the savings teller and Christmas- and vacation-club funds or other funds of a similar character for the current day. Against this, he credits himself with the amount of all checks and other items paid out. The difference should agree with the amount of cash on hand in the cage. At the close of business, if the proof sheet balances, the paying teller puts his paying cash into the vault, making sure that the receiving teller's cash, note teller's notes and everything that belongs in the vault has been put in.

It is again to be noted that this description of the paying teller's activities applies to a medium-sized bank. In larger institutions, some

of these activities may be taken charge of by other officials or departments.

Circulation.—In many smaller banks, the paying teller looks after the cutting of the bank's circulation and keeps a record of the amount and denominations destroyed by the Comptroller of the Currency and of the amount, denominations, and numbers of the new circulation issued.

Certification.—In smaller banks the paying teller generally has charge of the certification of checks. In larger banks there may be a certification department taking charge of this work. The actual certification in the sense of signing the check under the bank's stamp will be done ordinarily by the cashier or such other officer as has been especially authorized to certify by the board of directors. A certification is considered proper and binding upon the bank if done by an officer or employee who has been accustomed to certify with the knowledge and acquiescence of the directors, even though especial authority so to certify has not been delegated to him by the board.

To certify a check means that the bank agrees to honor that check when properly indorsed and presented for payment. Certified checks are immediately charged to the drawer's account, even though payment has not as yet been made. Thereafter the responsibility to honor the check becomes a direct obligation of the bank itself.

A bank is under no legal obligation to certify a check. It is optional with the bank, although all banks make a practice of doing it. Certification, however, should be refused in all cases of irregularity in the drawing of the check, where the payee is not properly identified, where the customer has advised the bank that he does not care to have his checks certified, where the authority of the individual making the request to certify is doubtful, and where the check is made payable to bearer. An interesting legal situation arises in respect to the possible certification of bearer checks. These might circulate as money, and make the bank liable to the Federal tax for issuing paper analogous to notes. Some clearing houses have regulations forbidding the members to certify bearer checks.

The certification must be in writing. An oral agreement on the part of the bank to honor the check is invalid and not binding upon the bank. For instance, a bank cannot be held responsible for refusing to honor a check when the holder previously inquired over the telephone of the cashier whether the check was good. The cashier replied that it was, but the bank received a *stop payment* notice prior to the presentation of the check. The bank thereafter refused to honor it and the

courts have upheld that position, holding that the telephone conversation did not amount to a certification. Certification by wire is valid, however. The agreement to honor the check need not be written upon the face of the check itself.

Overcertification.—Overcertification means the certifying of a check which is drawn for an amount in excess of the drawer's balance. Intentional overcertification by the bank is a criminal act in 25 states and is also forbidden in respect to Federal Reserve banks, National banks, and State banks which are members of the Federal Reserve System. Although overcertification is a criminal offense in most states, a bank cannot refuse to honor the check after it has been certified, as against an innocent holder of the check for value.

A bank has no right to certify a post-dated check, either at the request of the holder or drawer.

The certification may be made either at the request of the drawer of the check or the holder. Ordinarily, that matter is one of indifference, but there is a legal distinction involved if the bank fails prior to the presentation of the check, but after certification. For example, if the drawer of a check takes the check to the bank and has it certified prior to delivery to the payee, then delivers it to the payee, and the bank fails prior to presentation, the debt of the drawer to the payee is not satisfied, and the drawer is responsible to the payee for reimbursement for the amount of the check. If, however, the check has been delivered to the payee and the payee takes it to the bank and has it certified and thereafter the bank fails prior to the presentation of the check, it is the payee's loss and the drawer is no longer responsible to make the check good. These decisions are based on Sec. 188 of the Negotiable Instruments Act which provides: "Where the holder of a check procures it to be accepted or certified the drawer and all endorsers are discharged from liability thereon."

The principles which have hitherto been discussed in respect to the payment of checks after business hours apply also to certification. In other words, a bank may certify a check after or before business hours, if it so desires.

If a certified check is lost, the bank should demand an indemnifying bond from the drawer before releasing the funds.

The drawer of a certified check has the right to its ultimate possession, just as in the case of non-certified checks. However, it is the practice of many banks not to return such checks to the depositor when the account is settled, but to return a memorandum indicating the date, amount, etc., of the certified check, which is retained by the bank.

The depositor can, however, if he so desires, obtain possession of the certified check by returning the memorandum to the bank and signing a receipt for the check which is delivered to him. The certification does not have to be in any set form. A stamp, "Good when properly indorsed," with the signature of the proper banking official, is adequate. However, in certifying a check by wire, there must be an absolute and unequivocal promise to pay. According to "Paton's Digest" the following statements by telegraph have been held insufficient to constitute certification: "Check now good," "John Smith good on our books for $50 today," "Check is good," in reply to an inquiry "Is check good?" On the other hand, if written on the face of a check, the letters "OK" and the signature of a vice-president have been held to constitute a certification if the vice-president had authority to certify.

If a bank certifies a check when the drawer's signature has been forged, it is not entitled to charge the drawer's account, but it cannot refuse to honor the check in the hands of a bona fide holder who does not know of the forgery, or where there are no facts to put the holder on notice. When a bank certifies a check which has been raised, the majority of jurisdictions hold that it is not liable to pay the raised amount on the ground that the certification is simply an agreement on the bank's part to carry out the drawer's order and they have done so if they pay the amount originally inserted by the drawer. Some courts, however, have held that the bank is responsible to an innocent holder for value for the full amount of the check, although it is entitled to charge the drawer's account only with the original amount. Its liability in the case of forgery of the drawer's signature is based on Sec. 62 of the Negotiable Instruments Act. Alteration of the paper after the bank has certified it imposes no liability on the bank to the holder of the check.

Receiving Teller.—Deposit items come into the bank either across the counters or through the mails. In larger banks two separate tellers handle these items, the receiving or second teller, who takes in the items deposited over the counter, and the mail teller, who handles the items received through the mails. In smaller banks these two functions are combined, the receiving teller taking charge of both. Large city banks receive the bulk of their deposits through the mails. The reverse is true of the smaller country institutions.

The receiving teller comes into intimate contact with practically all of the customers of the bank and he is assisted by one or more assistant tellers, depending upon the size of the bank and the number of its

depositors. As a large part of the success of the bank is dependent upon the nature of the service that the bank performs, and the relationship existing between the public and the employees of the bank with whom it comes in contact, it is essential that the receiving teller be a man of pleasing personality, one who can courteously comply with the requests of the customers and one who can rapidly familiarize himself with their names and faces. Tellers should not be compelled to deal with more customers than they can properly accommodate, so that assistant tellers become necessary in larger institutions. A division of the windows alphabetically facilitates the recognition of the customers. One teller, for example, knows that he will deal only with customers whose names begin with a letter between A and D.

Receiving tellers take in the customers' deposits, which may be in the form of cash, checks, coupons, notes, and other negotiable instruments. The bulk of the deposits will ordinarily be in the form of checks.

As the receiving teller only receives funds, it is easier to check errors made by the receiving teller than is the case with the paying teller. Nevertheless, the receiving teller should be accurate and speedy in the counting of currency, and must pay strict attention to the checks and deposit slips to see that they are correct as to form and that there are no discrepancies in the listed amounts and totals, of the deposit slips. In the matter of checks, the receiving teller must make sure that the written and numerical sums are the same, that the check is not post dated, that it is in proper form and properly indorsed. He should check over the deposited items with the deposit slips to make sure that the amounts have been properly entered on the deposit slip, that no checks have been omitted, and that the total is correct. The bookkeepers, of course, credit the total on the deposit slips to the depositors' account. On the deposit of currency the teller should count the currency and make sure that the amount corresponds with that entered on the deposit slips. He should be able to detect counterfeit coins and notes. He is assisted in this by a *Counterfeit Detector*, published from time to time.

Coins of small denominations are frequently wrapped in certain amounts stated on the wrapper before being deposited. It is frequently impracticable for the tellers to break open these wrappings and count the individual coins, particularly if there is a long line at the window waiting to be served. Constant familiarity with such wrapped forms will generally enable the teller to judge by the size and weight whether a wrapper contains the exact number of coins which it purports to hold. These wrapped coins can be set aside and counted at

some later slack period, and if any error is found, the depositor can then be notified that his deposit did not correspond with the amount stated on the slips.

The teller credits the amount deposited in a pass book if that is presented by the depositor, or issues a duplicate deposit slip as a receipt at the depositor's request. The handling of the checks and other items after they have been received by the teller will be discussed in the chapter on Check Clearing and Collections.

A system known as the *unit system* has been of recent years adopted by a considerable number of banks. It is somewhat inconvenient for customers, when they wish both to deposit and to cash checks, to do this at two different windows. Many banks have, therefore, consolidated the duties of paying and receiving tellers so that both payments and receipts can be handled by the same teller at the same window. While this is a convenience to the customer, it imposes additional responsibility upon the tellers, who have to combine the knowledge and duties involved in both paying and receiving.

Proof sheets are kept by the receiving tellers showing the amounts received and these are balanced from time to time during the day with the currency and checks taken in. If the unit system is not used, the cash received, after being balanced with the proof sheet, can be turned over to the paying teller upon his receipt therefor. At the end of the day the total of checks and cash and other items received must correspond with the sum of the totals on the deposit slips. The checks are run off on an adding machine from time to time during the day and placed in bundles or racks, depending upon the destination or method of collection. In its essentials the same method of handling items is used by the mail teller.

Note Teller.—The note or third teller handles the promissory notes and other negotiable instruments, with the exception of checks deposited with the bank for collection. He also takes charge of the collections of notes and other instruments coming into the bank through the loan and discount departments. Each note must be examined by him for any informality in form; he must see that there are no alterations on the note, or erasures, and that it is properly signed and indorsed. In many banks the note teller performs the function of a discount clerk, taking charge of discounts under the general supervision of the cashier or other officials, and subject to the regulations of the board of directors. In very large banks the note teller's work may be subdivided and the city collections and coupon collections be assigned to other officials. In some banks the note teller takes over a number of miscellaneous

activities which are not especially assignable elsewhere as, for example, the issuance of certificates of deposit, the transfer of funds by telegraph, the delivery of mortgages, deeds, and other valuable papers, etc.

Banks act as collecting agents for their customers who send in notes, drafts, acceptances, and other items through various channels to be collected. Depositors of items for collection are given a receipt or the item is entered short in their pass book; or, in cases of customers making numerous collections, they may receive a collection book in which such items are entered when sent to the bank and marked off when paid or returned. The note teller also keeps a statement of all such items with their dates of payment and maturity which are marked off or noted when collected or paid. The bank in turn, of course, sends out numerous items of this character to its correspondent banks for collection in other localities. When the notes are payable locally, they are presented for collection by bank messengers under the direction of the note teller. Notes payable at the bank itself are charged against the depositor's account on the due date. In case notes are not paid, the collecting bank protests the note or not, depending upon the instructions it has received from the depositor or correspondent in the event of non-payment. Bonds and coupons are collected by presentation at the place where they are payable, either by messenger, if local, or by mail, if out of town.

Separate tellers may be assigned to the receipt of deposits for special purposes, as, for example, savings deposits, Christmas, Vacation, and other special club deposits, etc. The method of handling these items does not differ materially from the receipt of the ordinary deposits, except that receipt therefor may be made in some special type of pass book expressing the purpose and terms under which the deposits are received.

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CHAPTER XII

LOANS AND DISCOUNTS

Before discussing in detail the various types of loans, it would be well to define the negotiable instruments which are commonly used as a basis for credit extensions to commercial enterprises.

Forms of Commercial Paper.—*Promissory Notes.*—A promissory note is an unconditional promise in writing, by one person to another, signed by the maker, engaging to pay on demand or at a fixed or determinable future time a certain sum of money to the order of a specified person or to bearer. Such notes may be signed by an individual, a firm, or a corporation. The person making the promise is called the *maker* and the person to whom the promise is made the *payee*. The maker and the payee may be the same person, as when an individual or a firm draws a promissory note to the order of itself, indorses it, and discounts it with its bank. A promissory note may be either single name or double name, depending upon whether one or more than one person is responsible for the payment of the note.

Single-name paper is likely to originate as above described, when a mercantile house, desiring to borrow for some short-time business purpose, draws a promissory note to its own order and discounts it with its bank. The drawer is the sole person liable on the note. It is called single-name paper, even though the drawer may be a corporation consisting of a large number of stockholders; the corporation is nevertheless considered as a single entity. Notes signed by a partnership are likewise considered in banking parlance as single-name paper, even though all of the partners are liable for the partnership debts and even though the note may be indorsed by one or more of the partners individually. The indorsement by an individual partner does not increase his liability in any way, but simplifies the procedure on the part of the bank or other holder of the paper in enforcing his liability.

Double-name promissory notes arise out of business transactions in which the maker draws the note to the order of some other individual to whom money is due and owing. In order to discount such paper with the bank, the payee must indorse it, and by so doing becomes

liable to the bank for its ultimate payment. If the note is not paid at maturity, the bank or other holder thereof may enforce payment against either the maker, or the payee who has indorsed it. Such paper may be indorsed by other holders in due course who also become responsible for its payment, or by accommodation indorsers, who are responsible likewise for the payment of the note in the hands of holders in due course, whether or not they know that the indorsement was for accommodation only.

Occasionally commercial paper containing the indorsements of two or more individuals is called *secured paper*, the security in this case being the liability of the various indorsers. For the purpose of this discussion, however, the term *secured paper* will refer solely to commercial paper which is secured by the pledge of some definite collateral other than the simple liability of individuals whose names may appear on it.

Bills of Exchange.—A bill of exchange may be best defined in the words of the English bills of exchange act which says:

> A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time, a certain sum in money to or to the order of a specified person, or to bearer.

The person who draws the bill is called the *drawer*; the person to whom the payment is to be made is called the *payee*; and the person upon whom the order is made to pay is called the *drawee*. Bills of exchange are also commonly called *drafts*. If they are payable on demand, they are called *sight drafts* or *demand drafts*, and if payable at some future date are called *time drafts*. A foreign bill of exchange is a bill drawn in one country and of which the drawee and place of acceptance and payment are in another country. Ordinarily such foreign bills of exchange are payable in terms of the monetary unit of the country in which the draft is to be paid, but this is not always the case. Bills of exchange may be drawn upon either a person, a business firm, or corporation, or a bank or other financial institution. Sight drafts are ordinarily used as collection instruments for the collection of overdue accounts. For that reason they are not ordinarily discounted by banks but will be taken by banks for collection purposes only. Time drafts drawn on commercial houses for commercial purposes, if accepted or intended to be accepted before payment, are called *trade acceptances*. Time drafts drawn on banks if accepted or intended to be accepted are called *bank acceptances*. By *acceptance* is meant an

agreement on the part of the drawee to pay the draft at maturity. Such agreement to pay is ordinarily indicated by writing the word *Accepted* across the face of the draft together with the signature of the drawee.

Accommodation Paper.—Accommodation paper is a form of double-name paper. Accommodation paper, even when bearing the signature of two persons, is peculiar in that the indorsement is not necessarily connected with a business transaction at all, but is added for the purpose of giving strength to the note. Thus, the indorsement of an individual on the note of a corporation is evidence of the faith of that individual in the credit of the corporation, and adds personal security to corporate liability, should the note remain unpaid at maturity.

Trade Acceptances.—The Federal Reserve Board defines a domestic trade acceptance as:

> . . a bill of exchange drawn to order, having a definite maturity and payable in dollars in the United States, the obligation to pay which has been accepted by an acknowledgment, written or stamped, and signed across the face of the instrument by the company, firm, corporation, or person upon whom it is drawn, such agreement to be to the effect that the acceptor will pay at maturity according to its tenor, such draft or bill without qualifying conditions.

Several points are to be noticed about the scope of the term *trade acceptance* as above defined. The trade acceptance is a bill of exchange bearing on its face the *acceptance* of the person upon whom it is drawn. According to the law of negotiable instruments, the acceptance of the bill is the signification by the drawee (the person upon whom the bill is drawn) of his assent to the order of the drawer as represented by the terms on the face of the instrument. Although the acknowledgment of the validity of the debt represented by the face value of the bill may be stamped or written across the face of the instrument, nevertheless the Negotiable Instrument law requires that, to complete a *valid acceptance* such words as *approved* or *accepted,* with the date thereof, will not be a sufficient fulfillment of the law. The acceptance must be signed by the drawee. The phrase *tenor of the bill* is the request in the bill to pay the money at the time, place, and in the manner mentioned therein. A change by the acceptor of any one of those renders the acceptance qualified and thereby destroys the negotiability of the instrument.

For some time there was considerable effort made by Federal Reserve and other authorities to foster the growth of the use of trade acceptances in the United States as a method of financing to replace the

old open-book account system. For a time, special favorable discount rates were accorded to trade acceptances by the Federal Reserve banks and the Federal Reserve Act gave the Federal Reserve banks the privilege of purchasing trade acceptances as well as bank acceptances, although the purchase privilege was denied in respect to promissory notes. Certain abuses of the trade acceptance crept in, however; the open-book account and cash-discount system was found to be too deeply imbedded in American business customs to be readily dislodged. Today the campaign for trade acceptances is on the wane, and attention has been concentrated on bank acceptances.

Bank Acceptances.—The legal status of the bank acceptance is indicated in the following quotation: [1]

Any member bank may accept drafts or bills of exchange drawn upon it having not more than 6 months' sight to run, exclusive of days of grace, which grow out of transactions involving the importation or exportation of goods; or which grow out of transactions involving the domestic shipment of goods provided shipping documents conveying or securing title are attached at the time of acceptance; or which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples. No member bank shall accept, whether in a foreign or domestic transaction, for any one person, company, firm, or corporation to an amount equal at any time in the aggregate to more than 10 per cent of its paid-up and unimpaired capital stock and surplus, unless the bank is secured either by attached documents or by some other actual security growing out of the same transaction as the acceptance; and no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half of its paid-up and unimpaired capital stock and surplus: *Provided, however,* That the Federal Reserve Board, under such general regulations as it may prescribe, which shall apply to all banks alike regardless of the amount of capital stock and surplus, may authorize any member bank to accept such bills to an amount not exceeding at any time in the aggregate 100 per cent of its paid-up and unimpaired capital stock and surplus: *Provided, further,* That the aggregate of acceptances growing out of domestic transactions shall in no event exceed 50 per cent of such capital stock and surplus.

Acceptance of Drafts or Bills of Exchange Drawn upon National Banks by Banks or Bankers in Foreign Countries or Dependencies of the United States—Act of Sept. 7, 1916

Any member bank may accept drafts or bills of exchange drawn upon it having not more than three months' sight to run, exclusive of days of grace, drawn upon regulations to be prescribed by the Federal Reserve Board by

[1] Section 15, Federal Reserve Act as amended.

banks or bankers in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange as required by the usages of trade in the respective countries, dependencies, or insular possessions. Such drafts or bills may be acquired by Federal Reserve banks in such amounts and subject to such regulations, restrictions, and limitations as may be prescribed by the Federal Reserve Board: *Provided, however,* That no member bank shall accept such drafts or bills of exchange referred to in this paragraph for any one bank to an amount exceeding in the aggregate 10 per cent of the paid-up and unimpaired capital and surplus of the accepting bank unless the draft or bill of exchange is accompanied by documents conveying or securing title or by some other adequate security: *Provided further,* That no member bank shall accept such drafts or bills in an amount exceeding at any time the aggregate of one-half of its paid-up and unimpaired capital and surplus.

TYPES OF LOANS

Loans may be classified in various ways. For the purpose of this discussion they will be divided into secured and unsecured loans, and the secured loans in turn will be subdivided with reference to the nature or class of security pledged, into the following types: real-estate loans, loans on stock market collateral, stock brokers' loans, and merchandise loans.

Real-estate Loans.—Loans on real estate may be made by banks in several ways. Banks may take notes of the borrower secured by the pledge of real-estate mortgages; or they may make an outright purchase of the bond and mortgage; or of real-estate bonds secured by a mortgage in favor of some trustee for the benefit of the bond holders—in which case, of course, the bank receives the bond but not the mortgage.

For national and most state systems, banks are limited in respect to the quantity and nature of such real-estate loans, the limits being more severe in the case of the national system. Real-estate loans of national banks are limited and controlled by Sec. 24 of the Federal Reserve Act as amended by the McFadden bill. This section reads as follows:

Any national banking association may make loans secured by first lien upon improved real estate, including improved farm land, situated within its Federal Reserve district or within a radius of one hundred miles of the place in which such bank is located, irrespective of district lines. A loan secured by real estate within the meaning of this section shall be in the form of an obligation or obligations secured by mortgage, trust deed, or other such instrument upon real estate when the entire amount of such obligation or obligations is made or is sold to such association. The amount of any such loan shall not exceed 50 per cent of the actual value of the real estate offered for security, but no such

loan upon such security shall be made for a longer term than five years. Any such bank may make such loans in an aggregate sum including in such aggregate any such loans on which it is liable as indorser or guarantor or otherwise equal to 25 per cent of the amount of the capital stock of such association actually paid in and unimpaired and 25 per cent of its unimpaired surplus fund, or to one-half of its savings deposits, at the election of the association, subject to the general limitation contained in Sec. 5200 of the Revised Statutes of the United States. Such banks may continue hereafter as heretofore to receive time and savings deposits and to pay interest on the same, but the rate of interest which such banks may pay upon such time deposits or upon savings or other deposits shall not exceed the maximum rate authorized by law to be paid upon such deposits by state banks or trust companies organized under the laws of the state wherein such national banking association is located.

For the purposes of this act, the purchase by banks of mortgage bonds representing only a fractional part of the issue would not be considered as a loan on real estate, for the act provides that the transaction shall be considered a loan on real estate only when the entire amount of such obligation as a mortgage is made to or sold to the bank.

Location.—It is to be noted first, that the real estate upon which the loan is made must be located within the Federal Reserve district in which the lending bank is located, or within a radius of one hundred miles of the lending bank irrespective of whether this radius cuts across district lines. For example, a national bank in Philadelphia may, if it so desires, lend money on the security of real estate located in northern New Jersey if within 100 miles of Philadelphia, although northern New Jersey is located in the Second, whereas Philadelphia is in the Third Federal Reserve District.

Value of Security.—The provision that a national bank shall not lend an amount in excess of 50 per cent of the actual value of the real estate offered for security is made in the interests of safety and, if the bank is conservative in its valuations, safety should be obtained. However, the valuations are made by the officers of the bank and the provision of the law may be actually evaded by placing excessive valuations upon the properties. It is not intended to suggest that many banks consciously violate the provision of this act by overvaluing the real estate offered to them as collateral security. The national bank examiners may and frequently do appraise such real estate and if any excessive valuation is discovered, the Comptroller of the Currency would have the right to take steps to compel the bank to dispose of or reduce its loan. The limitation of lending only up to 50 per cent of the value of the property operates to reduce substantially the loans on real estate

made by national banks in comparison to similar loans made by state institutions which in general are not subjected to as rigid a limitation. Many state institutions will freely lend up to 60 per cent, or, in some cases, more, on the value of the real estate pledged.

Maturity.—The present law limits the maturity of the loan to 5 years. At the end of that period the bank may renew the loan for another period not in excess of 5 years provided the conditions at that time are such as to have warranted an initial loan for that amount. In other words, the property must be reappraised, and the 50 per cent limitation operates as of the value of the property at the time of the renewal. In fact, it is considered from a legal point of view as though it were a new loan. While the national banks have this right of renewal, they cannot enter into any binding agreement to renew at the time when the original loan is placed, provided the original loan plus the renewal agreement exceed the period of 5 years. As 5 years is a customary maturity period for mortgages, this provision does not materially affect, one way or another, the competitive status of national and state banks in respect to real-estate loans. But prior to the passage of the McFadden bill, national banks were limited to mortgages of 1 year maturity, if upon urban property, as distinguished from agricultural land. This 1-year maturity limitation was practically prohibitory upon the urban-mortgage business of national banks.

Type of Security.—Real-estate loans by national banks may only be on the security of improved and unencumbered property. Improved urban property is property upon which some structure is erected, and improved farm property means property which has been placed in condition for farming. The prohibition of loans on unencumbered property practically prevents national banks from entering the construction loan field. It is quite customary for builders or developers to buy a tract of unimproved land for the purpose of erecting buildings thereon. They frequently borrow from state banks prior to the initiation of any construction operations for the purpose of obtaining funds to finance the construction. They pledge with state banks a mortgage on the land which also covers the buildings as and when constructed. It is customary to place the mortgage on record prior to the initiation of any construction work for the purpose of placing the mortgage ahead of any claim for mechanics' liens. This cannot be done if the loan is from a national bank. The comptroller has ruled, in interpretation of the law, that no mortgage taken by a national bank for construction purposes can be placed of record prior to the initiation of construction; nor can the national bank advance under such a mortgage any sum

in excess of 50 per cent of the value of the land plus 50 per cent of the value of the present improvement on the property, although the mortgage may be written for an amount which will equal 50 per cent of the value of the land plus 50 per cent of the value of the completed improvement.

The provision that the property must be unencumbered means that there must be no lien prior to the mortgage, whether that lien be in the nature of another mortgage or mortgages, ground rent, judgments, or municipal or mechanics' liens. Consequently, a national bank cannot lend on the security of a second mortgage, no matter how small the first mortgage may be. A national bank may, however, lend money on the security of a first mortgage all or part of the proceeds of which are to be used to retire prior mortgages or to pay off other liens. The prior mortgages must be satisfied, however, and the liens paid off before the bank's mortgage is recorded.

Limitation of Amount Loaned to One Borrower.—Under the terms of another section of the McFadden bill, national banks are limited in the amount of real-estate loans which they may advance to any one borrower whether individual, partnership or corporation, to an amount not in excess of 10 per cent of the bank's unimpaired capital and surplus. They are also limited in the aggregate amount of real-estate loans which they may have outstanding at any one time. This aggregate limit is an amount equal to 25 per cent of the unimpaired capital and surplus of the bank or one-half of its savings deposits. Most state banking institutions are not subject to such rigid restrictions either in respect to the amounts of individual mortgages or the aggregate which may be advanced on mortgage security.

Loans on Stock-market Collateral.—Banks make many different types of loans on the collateral security of stocks and bonds and they may be classified in a number of ways. First, they may be classified in respect to time of payment, in which instance banks lend either on demand or for specified periods of time. They may be classified in respect to borrowers in that banks may lend to individuals or business houses on the security of stocks and bonds, or may lend to brokers. The latter loans are entitled *brokers' loans*, which in turn may be subdivided into time loans to brokers, demand loans to brokers, and special loans which are generally demand loans but made to brokers who keep deposit accounts with the lending bank.

In loans to individual customers of the bank who are not brokers, the pledging of collateral security is made where the credit of the borrower is not adequate to justify an unsecured loan. The stocks and bonds

pledged may be listed or unlisted securities, the banks, of course, preferring listed securities but frequently accepting unlisted securities from their best-known customers. The disadvantage of unlisted securities from the bank's standpoint lies partially in the difficulty of ascertaining the value of such securities and partially in the absence of a steady market for their resale. For the purpose of aiding the bank's officers in ascertaining the value of such unlisted securities, the customer is frequently required to accompany them with a recent financial statement of the concern whose stock is pledged and to keep the bank advised of all pertinent developments which may throw light upon the value of the securities. Banks will ordinarily require a larger margin of safety in respect to unlisted securities than they will require for listed securities having a fairly constant market. The employees in charge of the collateral security on loans follow their values daily from the financial reports of stock-market operations and if the value falls to a point where the loan is no longer adequately secured, the bank will either call the loan, if it is a demand loan, or request the deposit of additional collateral security.

A special type of demand loan which is sometimes called a *special loan* is often made to individuals who are well known to the bank, keep accounts there, and who are frequently officers or directors of the bank. These loans are made for the personal use of the borrower and are not expected or intended to be repaid in a short period of time. They may run for years, provided the interest is paid regularly and the collateral security is of a value to afford safety to the bank. The interest paid is generally at an agreed figure not subject to frequent variation, although, from time to time, if time interest rates change, the interest return on such special loans may be changed upon due notice being given by the bank.

A considerable proportion of the funds of most banks is loaned to brokers, directly by the larger banks in cities where there are stock exchanges, and indirectly by thousands of country banks who lend their funds through the agency of the city institutions. Large city banks may lend to brokers not only funds belonging to country correspondent banks but also funds of private depositors. In such cases the lending bank makes the loan in the same fashion as though it were lending its own funds, informing the customer of the rate of interest received, the collateral pledged as security, and all substitutions and changes of either rates or collateral. The lending bank assumes no responsibility other than the same degree of care which it exercises over its own loans, and generally charges a commission for its services.

Stock Brokers' Loans.—A small amount of money loaned by banks to stock brokers is made on time, but by far the largest part of such loans is demand loans and they are made by banks to brokers who keep no deposit account with the bank. There being no deposit relationship, the bank feels at perfect liberty to call such loans whenever the need arises, and those loans are the first to be called if the bank must retrench.

Although such loans are demand loans and therefore callable at any time, nevertheless it is not customary to call them on the same day that they are made. They are in practical effect considered as one-day loans and not callable until the following day although, of course, they may not be called then, but may run until such time as the broker pays them off, or until the bank needs funds. The custom in New York is to call such loans not later than 1:00 p.m., and the broker is generally allowed until 2:15 p.m. to make payment. This is only a customary procedure, however, and the bank is legally entitled to call its loan at any time up to the close of its business hours.

The rates charged upon such loans vary with the prevailing rates in the money market of the stock exchanges and may change daily, the bank notifying the borrowing brokers of changes in rate which they must either meet or repay the loans. This provision is subject to state legislation. In many states banks are limited in the maximum rate which they may charge. For example, until recently in the state of Pennsylvania, banks were limited to 6 per cent interest on their loans. During the prevalence of high rates in the market, this led to Philadelphia banks lending their money in New York, where call loans to brokers in amounts in excess of $5,000 had no legal rate limitation. This compelled brokers operating in Philadelphia to borrow most of their funds from New York sources, paying therefor the prevailing New York rate. Recently, the Pennsylvania legislature passed an act authorizing Pennsylvania banks to charge any interest rate on brokers' demand loans in excess of $5,000, placing the Pennsylvania banks on equality with the New York institutions in this respect. The state laws apply to both the state and national banking institutions, as the national law provides that national banks may charge whatever interest rate is legal in the state in which they do buisness.

The security deposited for brokers' call loans is ordinarily listed stocks and bonds which the brokers are carrying for their customers on margin, although some proportion of the deposited collateral may belong to the brokers themselves. The banks, for loans of any size, ordinarily

require some diversification of collateral so that in case of a declining market the likelihood that all of the collateral will decline at once will be minimized. There is no fixed rule as to this diversification, the banks merely insisting generally upon some proportion of industrial and of railroad securities. Some years back the railroad securities were favored, but today, with the increasing interest taken by the investing public in industrial securities, other than railroads, this emphasis is tending to disappear. The collateral, of course, must be properly indorsed and in a form which will make it available to the bank in case it becomes necessary to sell it to protect the bank from loss on the loan. The collateral agreement, signed by the borrower in connection with the loans, gives to the bank the right to sell securities and to purchase them. Banks, however, cannot sell the collateral security without giving to the borrower the proper legal opportunity either to repay the loan or to deposit additional collateral to insure its safety. As most of the collateral deposited by brokers has been purchased for customers' accounts, it is constantly being sold by the brokers and other stocks purchased. In order to complete the sales, the brokers have the privilege of withdrawing collateral from the bank upon the substitution of other adequate collateral.

The loans to brokers who are not deposit customers with the bank may be either made through the agency of money brokers or through the agency of the various stock exchanges, where money tables are established for the purpose of bringing together the borrowing brokers and the lending banks. In some few cases the loans may be made by direct contact between the borrowing broker and the bank, but the former is the prevailing method. The brokers submit to the officials in charge of the money table at the exchanges their requirements, and the banks furnish them with statements of the amounts available. These sums are allocated among the brokers who apply, and such loans are made at rates which are determined by the officials in charge of the money tables on the exchanges. Outside loans at other rates may, however, be made either by direct contact or through the intervention of money brokers.

Margins on Brokers' Loans.—The term *margin* here means the value of the securities in excess of the amount borrowed. The regular custom of large city banks is to require at least an excess of 20 per cent on loans secured, with the pledge of properly mixed or varied collateral. This margin may be lower where the security is bonds having comparatively little fluctuation in value, such as Federal government securities or the better class of state bonds, while a higher margin of value may

be required for the pledge of collateral security not well diversified or containing a large proportion of speculative issues or issues liable to fluctuate materially in an active market.

The interest rate charged is determined at the money table in the stock exchanges for the bulk of the brokers' loans. The relative supply of funds and demand for them in the morning will determine the renewal rate for the day. This rate is published on the stock-exchange tickers and upon receipt of the rate the bank clerks get out the rate notices to brokers, if the rate is changed, or call notices. This rate is not binding on either the brokers or the banks; if the brokers can borrow elsewhere at a better rate, they are, of course, entitled to do so; and the banks may charge a higher rate if the brokers are willing to pay. The rate may fluctuate during the day if different conditions arise. This daily fluctuation of rates ordinarily only applies to brokers' call loans. Banks do not make a practice of varying the interest rate which they charge their regular customers from day to day. The rate for loans to brokers on time is not determined in the stock exchanges, but results from the competitive activities of money brokers who make the rounds of the banks with their bids or offerings, depending upon whether they are representing the borrowers or lenders, and time rates are ordinarily not subject to the same rapidity of fluctuation as are call rates.

Day Loans.—Prior to the advent of the clearing corporations created in recent years for the purpose of clearing stock-market transactions on the big exchanges, brokers made settlements for the purchases and sales by certified checks between themselves. For the purpose of providing the brokers with the necessary certified checks in the morning for settlements of the preceding day's transactions, it was the custom of New York banks to agree to certify brokers' checks up to a given amount in spite of the fact that they greatly exceeded the amount which the broker had on deposit at the time certifications were made. It was understood, of course, that the broker would shortly thereafter deposit checks to his order in amounts sufficient to cover the certifications. This practice was forbidden to the national banks by the national banking law which prohibited overcertification of checks. In order to place the national banks upon an equality with the state banking institutions, as far as service to brokers was concerned, the national banks made a practice of granting one-day loans to brokers without interest to bring their morning balances up to the amount required for purposes of certification. This is still done to some extent, but the clearing corporations have reduced greatly the amount and number of certified checks so

required. Brokers, instead of paying for all their purchases by check and receiving checks for the sales, now only settle the balance by a single check to the clearing corporation, if they have a debit balance, or receive a check from the clearing corporation, if they have a credit balance. This operation is analogous in function to the clearing houses' clearing checks due and owing between banks.

CHAPTER XIII

LOANS AND DISCOUNTS (*Continued*)

Merchandise Loans.—Banks lend on the security of salable and standard merchandise which is either in the possession of a warehouse or in transportation. The banks, of course, do not take possession of the commodities themselves, but accept as collateral security either the warehouse receipt or the bill of lading. The loans are represented by either promissory notes, drafts, or bills of exchange and in the Federal Reserve Act and regulations such negotiable instruments secured by merchandise are termed *commodity paper*. The Federal Reserve Board's regulations define commodity paper as

> . . . a note, draft, bill of exchange, or trade acceptance accompanied and secured by shipping documents or by warehouse, terminal, or other similar receipts covering approved and readily marketable non-perishable staples properly insured.

Certain obvious defects are inherent in the granting of such loans by banks. The commodities may not be all of the same grade. They may be subject to shrinkage or deterioration, and for these reasons are more difficult to value than are listed bonds and securities. The result is that the bank must exercise considerable care in the granting of loans of this type.

Warehouse Receipts.—Warehouse receipts are documents of title to goods in storage issued by warehousemen to the depositor of the goods. In accepting such warehouse receipts as collateral security for loans, the first consideration of the bank is the nature of the legal lien obtained by such a pledge. Until comparatively recently, warehouse receipts were accepted by banks with considerable reluctance because of the probable legal difficulties of the bank's lien or claim on the goods. For example, under the laws of many states, an unpaid seller of the goods might have a claim prior to the claim of the bank lending on the security of the warehouse receipt. If the purchaser of a commodity stored it in a warehouse, obtained a receipt, and then borrowed from a

bank on the security of the receipt, without having paid for the goods, the original seller might be able to attach the goods as security for payment and the bank would thus lose its collateral.

Goods temporarily stored in a warehouse in process of shipment from one point to another were considered, under the laws of most states, as being in transit from seller to purchaser, and the familiar legal doctrine of stoppage in transit might be applied by the seller in case of the insolvency of the purchaser before delivery, to the detriment of the bank's lien. Under the statutes of many states, if the owner of commodities delivered them to a commission house or agent for sale, the owners could seize the goods in spite of the fact that the agent may have borrowed on them, pledging the warehouse receipt as collateral with the bank, the bank thus losing its lien. In addition to these legal defects, there was the practical disadvantage that the warehouse might not be properly operated. The goods would not be adequately protected from moisture, vermin, or other things which would result in a rapid physical deterioration, so that the bank could not be assured of a maintenance of the value of the commodities during storage and during the life of the loan.

These defects led to the appointment of a commission by the legislatures of a number of states to draft a uniform law relating to warehouse receipts. The law was drafted and enacted by practically all of the states of the union. In addition to that, Congress on Aug. 11, 1916, passed the United States Warehouse Act for the improvement of warehousing procedure and to fix the status of the rights of the various parties involved in the goods stored.

Uniform Warehouse Receipts Act.—Among other things, this act established a uniform form for warehouse receipts to place beyond question the negotiability or non-negotiability of these instruments, as the case might be, and by a number of provisions established beyond question the quality and nature of the lien possessed by the lender on the security of the receipt.

Under this law, the owner who sells goods on credit or entrusts his property out of his possession must take the risk of so doing and the bank or the individual who lends on warehouse receipts for such goods, without knowledge of any irregularity, is protected.

Section 40 of the uniform act provides in part:

> A negotiable receipt may be negotiated (*a*) by the owner thereof, or (*b*) by any person to whom the possession or custody of the receipt has been entrusted by the owner, etc.

Section 47 provides:

The validity of the negotiation of a receipt is not impaired by the fact that such negotiation was a breach of duty on the part of the person making the negotiation, or by the fact that the owner of the receipt was induced by fraud, mistake or duress, to entrust the possession or custody of the receipt to such person, if the person to whom the receipt was negotiated, or a person to whom the receipt was subsequently negotiated, paid value therefor, without notice of the breach of duty or fraud, mistake or duress.

The danger to the banks of the attachment, garnishment and possible delivery to the attaching creditor of the goods pledged has been done away with by Sec. 25, which reads:

If goods are delivered to a warehouseman, and a negotiable receipt is issued for them, they cannot thereafter, while in the possession of the warehouseman, be attached by garnishment or otherwise, or be levied upon under an execution, unless the receipt be first surrendered to the warehouseman, or its negotiation enjoined. The warehouseman shall in no case be compelled to deliver up the actual possession of the goods until the receipt is surrendered to him or impounded by the court.

Section 48 provides:

Where a person having sold, mortgaged, or pledged goods which are in a warehouse and for which a negotiable receipt has been issued, or having sold, mortgaged or pledged the negotiable receipt representing such goods, continues in possession of the negotiable receipt, the subsequent negotiation thereof by that person under any sale, to any person receiving the same in good faith, for value and without notice of the previous sale, mortgage, or pledge, shall have the same effect as if the first purchaser of the goods or receipt had expressly authorized the subsequent negotiation.

Section 49 provides:

Where a negotiable receipt has been issued for goods, no seller's lien or right of stoppage in transit shall defeat the rights of any purchaser for value in good faith to whom such receipt has been negotiated, whether such negotiation be prior or subsequent to the negotiation to the warehouseman who issued such receipt of the seller's claim to a lien or right of stoppage in transit. Nor shall the warehouseman be obliged to deliver or be justified in delivering the goods to an unpaid seller unless the receipt is first surrendered for cancellation.

In addition to these provisions giving legal protection to the bank or other holder of a negotiable warehouse receipt, the laws passed by most of the states provided for the licensing and inspection of ware-

houses, which has done much to prevent the deterioration or destruction of the pledged goods while in the possession of the warehouseman. However, it is one thing to pass a law; another, to enforce it. Under the fear that many of the states would not adequately enforce their warehouse laws or provide a sufficient body of inspectors to see that the provisions of the law were lived up to, the Federal legislature decided to act to reform the warehousing situation, and under date of Aug. 11, 1916, the United States Warehouse Act was passed.

United States Warehouse Act.—The announced purpose of this act was: (1) to encourage the farmer to properly store his products; (2) to eliminate unsound and evil practices in warehousing of agricultural products and at the same time to encourage uniformity in warehousing practices; (3) to encourage orderly marketing of agricultural products; (4) to develop a form of warehouse receipt, uniform in its terms, which would be acceptable to bankers generally as security for loans on agricultural products.

This act does not cover the storage of all goods. Only warehousemen storing agricultural products may take out a license under this act. Under the terms of the original law only cotton, grain, wool, tobacco, and flax seed were covered. In February, 1923, an amendment was passed authorizing the Secretary of Agriculture to add to this list such products as he may consider properly storable. Peanuts, potatoes, broom corn, dried beans, dried fruit, and syrups (maple and cane) have been added to the list.

Any warehouseman storing these products may make application to the Secretary of Agriculture through the Bureau of Markets for a license under the Federal act. Before the license is granted, the warehouseman furnishes a current financial statement and is subjected to an examination to determine the suitability of his warehouse for the storage of products, the competency of its management, the business reputation and financial standing of the warehouseman, his possession of the proper equipment for the care of the products, and of the proper facilities for weighing, inspecting, and grading them. In addition he must furnish an acceptable bond in an amount fixed by the Department of Agriculture to secure his compliance with the terms of the act. This bond is for the protection of the depositors and those dealing with the warehouse receipts who may suffer loss while the products are in storage due to the failure of the warehouseman to comply with the terms of the act. The surety on the bond must be an authorized and approved surety company and individuals injured may sue in their own name to recover under the bond.

Supervision.—Field examiners are employed by the Department of Agriculture to make frequent examinations of the warehouse, its condition, operation, and management and to check up upon the outstanding warehouse receipts and the quantity, kind, and grade of goods stored thereunder.

Receipts.—The act designates a form of receipt to be issued upon the storage of the products. The form is approved by the Secretary of Agriculture and must contain the following information:

1. The license number of the warehouseman.
2. The name and location of the warehouse.
3. The name and post-office address of the licensee.
4. Whether the receipt is negotiable or non-negotiable.
5. That the warehouseman is licensed and bonded under the United States Warehouse Act.
6. A number which corresponds to the number assigned to the package of the commodity in storage.
7. The name and address of the person from whom the commodity was received for storage.
8. Whether or not the commodity is insured and to what extent.
9. The period for which the commodity is accepted for storage, and the terms and conditions under which a new receipt may be issued.
10. The marks, the weight or quantity, the grade, and the condition of the commodity at the time it enters storage.
11. Whether the weight, grade and condition were determined by weighers, classifiers, and inspectors licensed under the law.
12. The standards according to which the grades were determined.
13. The amount of liens and charges claimed by the warehouseman.
14. The date of issuance of the receipt.
15. The signature of the warehouseman or his authorized agent.
16. If the warehouseman has an interest in the commodity represented by the receipt, the extent of that interest is shown on the face of the receipt.
17. A statement on the reverse side showing ownership of and any encumbrances or liens other than the warehouseman's liens which may be on the commodity.

The warehouseman must employ properly qualified persons to weigh and grade the stored products. These may, if desired, be licensed, and their competency and honesty is subject to periodical examination by the examiners of the Department of Agriculture.

The weight of the commodities stored must be stated in all instances, and the grade in all cases except where the identity of the stored product is maintained during storage. Even then, the grade must be stated unless the depositor requests its omission.

Warehousemen must deliver up the goods deposited upon presentation of the warehouse receipt properly indorsed, if accompanied by an offer to satisfy the warehouseman's lien and to surrender the

receipt, and to sign an acknowledgment of the receipt of the products delivered.

Warehousemen are required to keep correct records of products stored and withdrawn, and of the receipts issued, returned, and canceled. When required by the Secretary of Agriculture, they must furnish detailed reports, and their records and accounts are subject to examination.

The Secretary of Agriculture may revoke the license of warehousemen for any violation of the act or the rules and regulations of the department, or for the making of unreasonable or exhorbitant charges for services.

The act provides certain criminal penalties for the counterfeiting, forging, or using without proper authority any license issued under the act, or for the issuing or negotiation of a false or fraudulent receipt or certificate.

The cost of obtaining a license is nominal, as are the charges made for inspection. Licenses under the Federal act are not compulsory; that is to say, a warehouseman may choose whether he desires a Federal license or whether he would prefer to operate under state laws. It has been stated that insurance underwriters have recognized the value of government supervision and inspection, and have granted a lower rate for insurance to Federal warehousemen, which more than covers the cost of the Federal license and Federal inspections. In addition, the Federal license has a certain advertising value and may tend to attract business in competition with state-licensed warehousemen.

Warehouse Receipts as Collateral.—It is unquestionably true that the Uniform Warehouse Receipts Act and the United States Warehouse Act have so improved the legal status of the warehouse receipt and the operation and management of warehouses that bankers today have far less hesitancy in accepting warehouse receipts as collateral security for loans than formerly. Under date of Sept. 21, 1921, W. P. G. Harding, then governor of the Federal Reserve Board, issued a statement to the effect that although the Federal Reserve Board had no control over banks in regard to the character of loans made or the kind of collateral required from their customers, nevertheless he had no hesitation in expressing his opinion that warehouse receipts issued by warehousemen licensed and bonded under the United States Warehouse Act would be considered by bankers as more desirable collateral security than those issued by warehousemen not so licensed or bonded under any state or Federal law. He did not express any opinion as to the relative desirability of licensing under the U. S. Warehouse Act or under the

Uniform Warehouse Receipts Acts of the various states. He did say, however, that there was a certain advantage in being licensed under the Federal law, if the holders of warehouse receipts desired to use them as collateral for loans from banks located in states other than that in which the warehouse was located.

Shipping Documents.—In addition to loans on warehouse receipts covering storage of staple commodities, banks also lend on the security of shipping documents representing such commodities in shipment. The shipping documents are bills of lading issued either by railroads, shipping lines, or other carriers of goods and occasionally insurance papers insuring the goods in transit. Loans on railway bills of lading are seldom accompanied by insurance papers, as the railroads are liable for loss, damage, or unreasonable delay in most cases.

Certain risks attach to loans on bills of lading that do not apply to the same extent on loans on warehouse receipts. For example, a bill of lading does not guarantee the quality of the goods shipped; the railroad companies do not employ graders as do many of the warehousemen. On the contrary, the railroad company ordinarily accepts the shipper's statement as to the quantity and quality of the goods shipped. The bill of lading simply says that the packages are *said to contain* certain goods. In consequence, loans on bills of lading are made largely upon the bank's knowledge of the honesty and high character of the shipper, somewhat less reliance being placed upon the quality of the security pledged than in the case of loans on warehouse receipts.

Trust Receipts.—In loans made either on warehouse receipts or on bills of lading, it is frequently necessary for the borrower to obtain possession of the goods before the loan is paid. This is particularly true in the case of the shipment of goods where an importer has borrowed on the security of the bill of lading and needs the goods for manufacture or sale, his disposal of the goods being the source of funds with which he expects to meet his bank loan. Under these conditions, the bank cannot at the same time retain possession of the goods as collateral security for the loan and the borrower sell the goods to obtain funds to repay the loan. This difficulty is occasionally met by substitution of collateral; for example, the borrower may obtain possession of collateral originally pledged by substituting other collateral in its place; but the customary method is to permit the goods to be delivered to the borrower on trust receipt.

A trust receipt is a trust agreement or contract whereby the borrower is placed in the possession of the goods which have been pledged as collateral security for a loan without the abandonment by the bank of its

title to the goods. Trust receipts vary considerably in form. They may be created solely for the purpose of permitting an importer to obtain possession of goods from the ship for the purpose of storing them in a licensed warehouse. In this case the bank will deliver to the importer the bills of lading under a trust receipt which says in effect that the bill of lading delivered to the importer is to be used solely for the purpose of obtaining the property and storing it as the property of the bank in a specified warehouse. It further provides that upon storage the warehouse receipt will be substituted in place of the bill of lading.

If, however, the importer has already obtained a purchaser for the goods, or desires to manufacture them into some other product, they will not be warehoused and that form of trust receipt would not be applicable. If the bill of lading or warehouse receipt is to be delivered for the purpose of a sale of the goods, it would state in effect that the purpose of giving up the bill of lading or warehouse receipt by the bank was solely to permit the borrower to obtain possession of the goods for the purpose of delivering them to the purchaser, and to obtain from the purchaser the proceeds of the sale. There would follow an agreement to immediately turn over the proceeds to the bank to be applied against the indebtedness and a statement to the effect that, until such proceeds were delivered, the borrower was holding first the goods and later the proceeds in trust for the bank.

If the goods are to be delivered to the borrower for the purpose of manufacture, the trust receipt would contain a provision to the effect that the property was delivered to the importer to hold as the property of the bank with liberty only to manufacture and sell the same, accounting for the proceeds to the bank, but without liberty to pledge the goods in any way until all indebtedness to the bank had been paid or satisfactorily provided for.

The legal status of the trust receipt is a matter of considerable doubt. Although it is called a trust receipt, it is evident that no trust relation is established in the ordinary conception of that word. To establish a trust it is ordinarily required that the title to property be placed in a trustee for the benefit of some other party, known as the beneficiary or cestui que trust. In the case of a trust receipt, however, the document states that the title to the property remains in the bank, although possession of the property has been given to the borrower. It is apparent, then, that the word *trust* here signifies only some contractual relationship between the parties.

The situation arising out of trust receipts differs from the arrangement which ordinarily constitutes a pledge. A pledge is predicated

upon the possession of the goods by the party secured, and when possession is lost, so is the security. Under the trust receipt, effort is apparently made to give up the possession without abandoning the title or security. The trust receipt differs from a conditional sale primarily in the fact that the lending bank is not in the business of selling goods, does not purport to sell them to the borrower, and upon default of the borrower will sue for money loaned and not for damages for breach of contract in failing to buy and pay for goods.

It has been claimed by some that the bank possesses a lien on the property somewhat analogous to the lien of a chattel mortgage. Under the laws of most states, however, a chattel mortgage is not a lien as against creditors or bona fide purchasers for value, unless recorded, or unless the creditors or purchasers have actual notice of the existence of the chattel mortgage. Trust receipts are not recorded and it is difficult to see how under any law of chattel mortgages the bank could retain a lien as against purchasers for value or creditors of the borrower. All things considered, however, it would appear that the trust receipt bears the closest resemblance to a chattel mortgage—with this important difference, that, in the case of a trust receipt, the title of the bank to the goods is derived from some third party, and not from the debtor, whereas, in the ordinary case of a chattel mortgage, the title of the bank would be derived from the borrower himself.

Various decisions in the courts of different states cannot all be reconciled, but in general it may be said that, except in some few states, property delivered to the signer of a trust receipt where title to the property is not derived by the bank from the signer of the trust receipt may, if identified, be retaken by the bank at any time before the satisfaction of the obligation secured by the trust receipt. It may be retaken not only from the signer, but also from his receiver, assignee trustee in bankruptcy, or attaching creditor. The proceeds of the sale or disposition of the goods may likewise be retaken, if they can be identified. Otherwise, the bank would have a right only of suit for the amount involved.

A complete discussion of the legal status of trust receipts cannot be made within the scope of this work. The reader is particularly referred to an able pamphlet by Karl T. Frederick, "The Trust Receipt as Security," published by the American Acceptance Council.

Unsecured Loans.—Banks may, and frequently do, lend money on the credit standing of the borrower alone, and such loans are termed *unsecured loans.* There is no legal limit to the quantity of unsecured loans in relation to secured loans that a bank may make. It is a mat-

ter of business policy alone. Obviously, in the making of such loans, a closer scrutiny must be made of the credit standing and position of the borrower, as the ultimate repayment of the bank is dependent upon the commercial success of the borrower or private, unpledged wealth that he may possess.

When such unsecured loans are made by a commercial bank, they are almost exclusively made for strictly commercial purposes and should be self-liquidating. The term *self-liquidating* in this sense means that the proceeds of the loan are to be used for an immediate commercial purpose which will result in proceeds sufficient to pay the loan at maturity. For example, such unsecured loans are frequently made to merchants to enable them to take advantage of cash discounts in the purchase of the goods which they resell. The wholesaler may purchase goods on terms of 30 days net, 2 per cent 10 days, meaning that he is expected to pay for the goods which he has purchased at the contract price within 30 days after they are shipped to him, but that a 2 per cent discount on the purchase price will be allowed if he pays for them within 10 days. Ordinarily this discount is in excess of the cost of money to the merchant. In other words, he would profit by borrowing from a bank at 6 per cent per annum money sufficient to take advantage of a discount of 2 per cent on the purchase price of goods. Banks in extending loans for this purpose will try to time the maturity of the loan in such a way that the wholesaler can dispose of the goods so purchased and collect from his customers at about the same time that the bank loan falls due. He is thus in possession of funds sufficient to liquidate the bank loan.

This is the ordinary meaning of the term self-liquidating. In practice, it does not always work out in quite that simple fashion. It is not always possible for the merchant to isolate individual transactions in just that way. A merchant is buying fairly continuously and selling fairly continuously, and the proceeds of a single loan may be utilized to take advantage of a number of cash or trade discounts on a number of successive purchases. The bank loans are timed, then, not to meet the exact conditions arising out of any one transaction but are timed to correspond to the average rate of turnover of the inventory of the merchant. The method of ascertaining the rate of turnover will be indicated in the discussion of credit analysis.

Unsecured loans should ordinarily not be made when the borrower is going to use the funds for investment, or for consumption purposes, or for any other purpose which will not operate to put him in possession of funds to meet his maturing loans. This statement is meant to apply

to the commercial activities of a bank and not necessarily to any so-called industrial loans which it may make through the operation of an industrial loan department.

Loans or Gratuities to Bank Examiners Prohibited.[1]

a. No member bank and no officer, director, or employee thereof shall hereafter make any loan or grant any gratuity to any bank examiner. Any bank officer, director, or employee violating this provision shall be deemed guilty of a misdemeanor and shall be imprisoned not exceeding 1 year, or fined not more than $5,000 or both, and may be fined a further sum equal to the money so loaned or gratuity given.

Any examiner or assistant examiner who shall accept a loan or gratuity from any bank examined by him, or from an officer, director, or employee thereof, or who shall steal, or unlawfully take, or unlawfully conceal any money, note, draft, bond, or security or any other property of value in the possession of any member bank or from any safe deposit box in or adjacent to the premises of such bank, shall be deemed guilty of a misdemeanor and shall, upon conviction thereof in any district court of the United States, be imprisoned for not exceeding 1 year, or fined not more than $3,000, or both, and may be fined a further sum equal to the money so loaned, gratuity given, or property stolen, and shall forever thereafter be disqualified from holding office as a national bank examiner.

Loans On or Purchase of Their Own Stock Forbidden.[2]

No association (national bank) shall make any loan or discount on the security of the shares of its own capital stock, nor be the purchaser or holder of any such shares, unless such security or purchase shall be necessary to prevent loss upon a debt previously contracted in good faith; and stock so purchased or acquired shall, within 6 months from the time of its purchase, be sold or disposed of at public or private sale; or in default thereof, a receiver may be appointed to close up the business of the association, according to Sec. 5234.

The National Bank Act, as amended, contains certain provisions limiting the amounts that national banking associations can lend to any one customer on the security of certain types of paper. These loan limitations are as follows:

Liabilities to an Association which May Be Incurred by Any One Person, Company, etc.—(Sec. 5200, Revised Statutes of the United States, as amended by McFadden bill, Sec. 10).

The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per cent

[1] Federal Reserve Act, as amended.

[2] Section 5201, United States Revised Statutes.

of the amount of the capital stock of such association actually paid in and unimpaired and 10 per cent of its unimpaired surplus fund. The term "obligations" shall mean the direct liability of the maker or acceptor of paper discounted with or sold to such association and the liability of the indorser, drawer, or guarantor who obtains a loan from or discounts paper with or sells paper under his guaranty to such association and shall include in the case of obligations of a copartnership or association the obligations of the several members thereof. Such limitation of 10 per cent shall be subject to the following exceptions:

1. Obligations in the form of drafts or bills of exchange drawn in good faith against actually existing values shall not be subject under this section to any limitation based upon such capital and surplus.

2. Obligations arising out of the discount of commercial or business paper actually owned by the person, copartnership, association, or corporation negotiating the same shall not be subject under this section to any limitation based upon such capital and surplus.

3. Obligations drawn in good faith against actually existing values and secured by goods or commodities in process of shipment shall not be subject under this section to any limitation based upon such capital and surplus.

4. Obligations as indorser or guarantor of notes, other than commercial or business paper excepted under (2) hereof, having a maturity of not more than 6 months, and owned by the person, corporation, association, or copartnership indorsing and negotiating the same, shall be subject under this section to a limitation of 15 per cent of such capital and surplus in addition to such 10 per cent of such capital and surplus.

5. Obligations in the form of bankers' acceptances of other banks of the kind described in Sec. 13 of the Federal Reserve Act shall not be subject under this section to any limitation based upon such capital and surplus.

5. Obligations of any person, copartnership, association or corporation, in the form of notes or drafts secured by shipping documents, warehouse receipts, or other such documents transferring or securing title covering readily marketable non-perishable staples when such property is fully covered by insurance, if it is customary to insure such staples, shall be subject under this section of a limitation of 15 per cent of such capital and surplus in addition to such 10 per cent of such capital and surplus when the market value of such staples securing such obligation is not at any time less than 115 per cent of the face amount of such obligation, and to an additional increase of limitation of 5 per cent of such capital and surplus in addition to such 25 per cent of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 120 per cent of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per cent of such capital and surplus in addition to such 30 per cent of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 125 per cent of the face amount of such additional obligation, and to a further additional increase of limitation of

5 per cent of such capital and surplus in addition to such 35 per cent of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 130 per cent of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per cent such of capital and surplus in addition to such 40 per cent of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 135 per cent of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per cent of such capital and surplus in addition to such 45 per cent of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 140 per cent of the face amount of such additional obligation, *but this exception* shall not apply to obligations of any one person, copartnership, association or corporation arising from the same transactions and/or secured upon the identical staples for more than 10 months.

Obligations of any person, copartnership, association, or corporation in the form of notes or drafts secured by shipping documents or instruments transferring or securing title covering livestock or giving a lien on livestock when the market value of the livestock securing the obligation is not at any time less than 115 per cent of the face amount of the notes covered by such documents shall be subject under this section to a limitation of 15 per cent of such capital and surplus in addition to such 10 per cent of such capital and surplus.

Obligations of any person, copartnership, association, or corporation in the form of notes secured by not less than a like amount of bonds or notes of the United States issued since Apr. 24, 1917, or certificates of indebtedness of the United States, shall (except to the extent permitted by rules and regulations prescribed by the Comptroller of the Currency, with the approval of the Secretary of the Treasury) be subject under this section to a limitation of 15 per cent of such capital and surplus in addition to such 10 per cent of such capital and surplus.

References

KILBORNE, R. D.: "Principles of Money and Banking," Chap. XX.
WESTERFIELD, R. B.: "Banking Principles and Practice," Chap. XXIX.

CHAPTER XIV

CREDIT ANALYSIS

The chief source of earnings of a commercial bank is the interest and discount collected on loans and discounts. The bulk of the funds received from the sale of capital stock, the retained earnings of the bank, and the deposits are loaned by the bank to customers, and it is the function of the departments in charge of loans and discounts to handle and record these items. The loans and discounts themselves are made by officers of the bank to whom that function has been delegated under the supervision and control of the board of directors. In theory, the granting of loans and discounts is a function of the directors, and that function can be delegated to officers of the bank only by specifying the officer or officers who have that power, and the conditions under which loans may be granted, as, for example, the aggregate sums which they must not exceed and such other limitations as the directors deem necessary. The board of directors may also, and frequently does, delegate to a smaller committee of the board the function of passing upon loans and discounts in the intervals between directors' meetings. Under either or both of these circumstances, however, all of the loans and discounts made are regularly reported to the board of directors for its approval. It is, of course, impossible for the board of directors to function daily and pass immediately upon all applications for loans and discounts. Another method of handling the delegation of authority is to grant to certain of the larger borrowers a *line of credit*, that is to say, specifying a certain sum up to which a given customer may borrow. These *lines of credit* are based upon periodic credit investigations of the customers to whom they are granted, and they run for limited periods of time. At the end of that period, they are either renewed, canceled, or continued for some other sum.

Credit Analysis.—Lending operations involve the element of risk. There is uncertainty as to whether or not the persons liable on the instrument will pay it at maturity, or at any other time. This element of risk in the main operations of a bank leads to the necessity for credit investigation. Before a bank lends to a customer, it wishes to be

assured with as high a degree of certainty as is compatible with the conditions, that the loan will be repaid. This ordinarily necessitates a credit investigation of the financial standing, worth, and character of the borrower. The degree of the investigation will be greater or less, depending upon the amount of the loan and whether the loan is or is not otherwise secured. Loans made by a bank may be either unsecured, or secured by the deposit of collateral security. Collateral security consists of the pledging with the bank of some form of wealth to which the bank can look for reimbursement, in case the loan is not paid at maturity. The collateral may take the form of stocks, bonds, or mortgages, bills of lading, warehouse receipts, commercial paper, etc. Obviously, if the collateral security pledged with the loan has an easily realizable value equal to or in excess of the loan made, the same degree of credit investigation is not so necessary as in the case of an unsecured loan or a loan where some collateral is pledged, but collateral of doubtful value. Some degree of credit investigation, however, would probably be made even in the case of a collateral loan, if the loan were of substantial size; for banks do not like to realize upon collateral pledged, if they can avoid it, but prefer to be paid by the borrower at maturity without recourse to other proceedings.

The credit investigation of borrowers is in charge of a credit department and a credit officer, if the bank is large enough to justify this degree of departmentalization. In smaller banks, the credit investigation is taken charge of by the loan officers as a part of the routine of making loans.

The Work of the Credit Department.—The increase in the size of banking institutions has developed the practice on the part of large banks of operating separate credit departments. This department not only builds up voluminous records concerning the status of customers of the bank, but in addition makes credit investigations for the bank and, very often, for the clients of the bank. It is also frequently called upon to make an analysis of the statements presented to the bank by applicants for credit. Modern banking practice insists that commercial borrowers furnish the banks periodically with financial statements showing the condition of their business.

A large bank serves as correspondent for a number of smaller institutions, which frequently avail themselves of the services of the credit department of the urban institution; thus, the credit department becomes the clearing house for information concerning the customers of banks.

The size of the credit department, of course, depends upon the

volume of business done by the bank, together with the general plan of the officers of the institution. It might employ a number of special investigators, or it might depend upon general credit agencies and the cooperation of credit departments of other business institutions for its information. The work of the Robert Morris Associates, a national organization of bank credit men, maintaining a permanent central office, has done a great deal to disseminate credit information among the credit departments operated by the banks of this country.

Method of Credit Investigation.—Every one is familiar with the four C's which form the basis of credit analysis, namely, *character*, *capacity*, *capital*, and *collateral*. These are largely self-explanatory. They imply simply that the bank is desirous of satisfying itself that the applicant for the loan is an honest man of high character who has every intention of fulfilling his obligation to the bank; that he has sufficient capacity to enable him to carry on his business successfully, and to successfully utilize the proceeds of the loan so that it may result in funds sufficient to liquidate it at maturity; that the borrower has sufficient capital or resources to properly carry on his business affairs; and, finally, in the absence or shortage of any of the foregoing qualities, that he has adequate collateral to pledge with the loan in order to secure its repayment.

There is little question as to what should be investigated in respect to the credit standing of applicants. The chief question in respect to credit investigation hinges upon the method of the investigation and the sources of information which may be utilized.

Sources of Credit Information.—There are two types of sources of credit information: that derived from the borrower himself, and that derived from outside sources. The outside sources will be discussed first.

Mercantile Agencies.—There are in existence mercantile agencies whose sole business is to collect credit information concerning most of the business houses of any standing in the country. There are three general classes of these agencies: first, the national agency which includes in its reports all kinds of businesses; second, national agencies limiting their information to certain lines or related lines of trade, such as jewelry, textiles, furniture, etc.; and, third, local agencies, which cover all business in one locality. The best-known national agencies are R. G. Dun & Company, and Bradstreet. These national agencies issue at periodic intervals a book which lists business concerns and gives to them a capital or net-worth rating and also classifies them according to their manner of meeting payments. While most banks make a prac-

tice of keeping in their files one or both of these national rating books, nevertheless there are certain obvious disadvantages connected with them. They are, ordinarily, only used when immediate judgments must be made and serve only as a basis or start for a more detailed credit investigation. Because of their size it takes some time to compile the information contained in the books, and, therefore, they are of necessity some months out of date when received by the banks. The ratings contained therein are based primarily upon information received from the companies themselves, chiefly in the form of financial statements and so far as the bank's customers are concerned, the bank itself should be in the possession of the same statements upon which the national agencies' ratings are based. These rating books, however, are conservative in their ratings and serve a useful purpose. Although seldom taken as final by the bank credit man, nevertheless it is interesting to note that, of the commercial failures in the country, over 90 per cent of them had either nominal or no credit ratings in Dun or Bradstreet, and less than 1 per cent of the failures came from the very good or highest ratings in the books.

These national agencies will make special reports for their customers on any credit risk. Such special reports covers material which has been received since the issuance of the last volume, and other important news items concerning the subject of the inquiry, such as foreclosures, lawsuits, placing of mortgages, pledging of accounts receivable, fires, or other serious losses, or any other information collected by the agency which might have a bearing upon the credit standing of the company investigated. Upon request, a complete report will be submitted, covering the history of the company; the composition of its members, officers, directors, etc.; full details of latest statements issued by the company with comments thereon; such facts as can be ascertained concerning the character, habits, and business capacity of the members of the firm, or officers or directors thereof; comments regarding the location, business outlook, etc., for the company; and, finally, a digest of trade opinions and experiences of other credit men.

Special Agencies.—The chief defects of the national agencies are due to the scope of their activities. Covering, as they do, such an enormous field, it is a matter of physical impossibility to give very detailed attention to the individual businesses listed. To remedy this defect, special agencies have arisen limiting their activities to narrower fields. These special agencies vary in size from those agencies which purport to cover entire fields of business, to individual investigators, who, for a fee, will make a personal investigation of individual credit risks.

Credit Cooperation.—The interchange of credit experience is a recent development in credit investigation. While interchange of ledger experience is primarily applicable to business concerns rather than to banks, nevertheless, banks frequently take advantage of such interchange of credit experience by joining organizations devoted to that purpose. Such organizations may term themselves credit clearance agencies, or trade bureaus, and there are several national organizations disseminating credit information, such as the Interchange Bureau of the National Association of Credit Men, the Credit Clearing House, the National Credit Office, and others. They all operate under the general principle of having their members report to a central office their experiences in the matter of payments with their customers, which information is made available to other members of the organization.

Press and Trade Journals.—A great deal of valuable credit information can be obtained from the daily papers and from trade journals furnishing items of news concerning various business lines. Information concerning suits against customers of the bank, foreclosure proceedings, fires, special sales, marriages, deaths, social activities, etc., give to the bank credit manager a picture of the conditions and circumstances of their customers' lives and business affairs which are pertinent in credit inquiries. In most of the larger banks the daily papers and other trade journals are read and items extracted therefrom which are kept in the files pertaining to the bank's customers. Papers and journals contain not only much of particular interest concerning customers, but also items of general importance in reference to business conditions which will affect the profits and financial success of the bank's borrowers.

Banks as a Source of Credit Information.—Banks obtain a considerable amount of credit information from each other. Because of the possible reciprocity, banks are generally more willing to give credit information to other banks than they are to their private customers, or to the public. As banks have very intimate relations, verging on the professional, with their borrowers and customers, they are in possession of a considerable fund of information concerning the financial affairs of their customers which they consider in a high degree confidential and will ordinarily not disclose to individuals making inquiries; but as between the banks themselves, information of a general nature is exchanged. The necessity of getting credit information from other banks arises chiefly in respect to the purchases of commercial paper of business houses located in districts other than the locality of the bank. Under those circumstances the bank officials proposing to purchase the

paper will frequently write to large banks in the locality of the issuing house, asking their opinion as to the quality of the paper and the standing of the business firms selling the same. Without giving intimate details of the financial status of the business house, the bank will express an opinion under those circumstances as to the advisability of purchasing the paper, expecting to receive like courtesies in return from the inquiring bank.

Personal Conferences.—In addition to the external sources of credit information as briefly outlined above, there are certain internal sources of great importance. The first and most obvious of these is the information which can be derived from the borrower himself by personal conference. Indications as to the character of the applicant for a loan may be ascertained by the relative frankness with which the applicant will explain the details of his business, the purpose to which the proceeds of the loan are to be put, and the source of funds from which he expects to retire the loan at maturity. Adroit questioning by a bank credit officer will frequently enable him to gauge with considerable accuracy not only the character of the borrower, but the knowledge and efficiency with which he can conduct his business operations. Any indications that the applicant does not thoroughly know his own business, that he is attempting to conceal important facts from the bank, would create doubts in the mind of the bank credit officer as to the advisability of making a loan.

Personal conferences may be supplemented by inspection of the applicant's business plant and such inspection will disclose to a skilled credit officer much information as to the status of the business and the efficiency with which it is managed and operated.

Financial Statement.—The chief internal source of credit information, however, is derived from a study of the financial statements of the borrowers' business. Of recent years it has become a matter of common practice with banks to insist upon borrowers furnishing them with periodic statements, both balance sheets and income reports, disclosing, under careful analysis, the condition of the borrower's business. The possession of such statements is obligatory on the bank when seeking to rediscount borrowers' paper with the Federal Reserve banks in sums exceeding $5,000.

A financial statement should comprise three main parts—a balance sheet, an income statement, and reconcilement of surplus record. A complete picture of the condition of the business cannot be obtained unless these appear. A balance sheet is drawn up as of a given date and shows at that moment the total value of the assets and liabilities

of the business, whereas the income statement is made up for a period of time showing the result in dollars and cents of the operations of the business over that period. It is obvious that the balance sheet may be drawn up at a particular moment when the business is in a peculiarly favorable condition, which condition may not have prevailed a short time prior to the preparation of the statement, and may not prevail a short time subsequent thereto. This difficulty is partially corrected by the income statement, which indicates the relative success of the business over a period of time. In addition, a series of balance sheets showing the condition of the business at successive periods is a necessity for a complete picture. The successive balance sheets have the further advantage of indicating the direction in which the business is tending. For example, it is generally a preferable risk if a business is on the upgrade rather than on the downgrade, although the statement at the period when the loan is requested may be strong in both cases. If business *A* is improving its position from year to year, it may be a better credit risk than business *B*, which is moving in the opposite direction, even though the current statement of business *B* appears stronger than business *A*. This comparison of successive statements of a business is known as *comparative statement analysis*, and is a recent development in credit analysis.

The statement on page 189 is a typical form of balance sheet, as recommended by the Robert Morris Associates.

This statement represents an attempt to standardize the form of the financial statements. Such a standardization greatly facilitates the work of credit men in the analysis of financial statements. Not only do they become familiar with the customary forms in which the statements will appear, but unless some form of standardization exists within a given business over a period of time, the problem of comparative statements analysis becomes one of extreme difficulty. It is almost impossible to compare the state of a business now with its condition a year or two ago, unless the form of statement is sufficiently similar to permit intelligent comparisons to be made.

Another aid to proper credit analysis today is the growing practice of having the accuracy of the figures in the statement verified by public accountants of responsible standing. This verification is of particular importance if the auditing firm certifies not only to the accuracy of the statement as taken from the books, but also makes an independent appraisal or valuation of the assets listed therein.

Balance Sheets.—It will be noted that the balance sheet consists of two main parts, the assets or resources of the business, and its liabilities.

The difference between the actual assets and liabilities represents the net value of the business, which will appear as stock and surplus if the business is incorporated, or as the partners' equity or individual's equity if the business is not incorporated. These equities are listed as liabilities because of the practice of considering them as debts owed to the

(Form adopted and published by the Robert Morris Associates)

FINANCIAL STATEMENT **CORPORATION**

Corporate Name ____________________

Business ____________________ Address ____________________

STATEMENT FOR

CONDITION AT CLOSE OF BUSINESS ____________________ 19____

ASSETS	LIABILITIES AND NET WORTH
Cash—On Hand, $ ____	Notes Payable for Merchandise
In Bank, $ ____	Trade Acceptances—Payable
Notes Receivable of Customers—Due within 90 days	Notes Payable to Banks
Notes Receivable of Customers—Due beyond 90 days	Bankers Acc. (Amt. Secured, $ ____)
Trade Acceptances of Customers	Notes Payable for Paper Sold
Accts. Receivable of Customers—Not Due	Notes and Accounts Payable to Officers, Directors and Stockholders
Accts. Receivable of Customers—Past Due	Notes Payable to Others
*Mdse.—Finished (How Val ____)	Accounts Payable—Not Due
*Mdse.—In Process (How Val ____)	Accounts Payable—Past Due
*Mdse.—Raw (How Val ____)	Deposits of Money with us
*Mdse.—In Transit	Provision for Federal Taxes
U. S. Government Obligations	Accrued Interest, Other Taxes, Etc.
Other Cur. Assets—(Itemize on Page 3)	Chattel Mortgages
TOTAL CURRENT ASSETS	Portion of Funded Debt Maturing
Due from Controlled or Subsidiary Concerns—For Merchandise	Other Current Liabilities (Itemize Pg. 4)
Due from Controlled or Subsidiary Concerns—For Advances	TOTAL CURRENT LIABILITIES
Stocks, Bonds and Investments—(Itemize on Page 3)	Mortgages or Liens on Real Estate
Land	Bonded Debt
Buildings (Before Depreciation. See Reserve Contra)	Any Other Liabilities—Itemize
Machinery, Equipment & Fixtures (Before Depreciation. See Reserve Contra)	
Notes and Accounts Receivable—Due from Officers, Stockholders & Employees	(TOTAL DEBT)
Goodwill, Patents and Trade Marks	Reserves—Itemize
Prepaid Expenses	
Other Assets—Itemize	
	Capital Stock Outstanding:
	Preferred
	Common: (Par $ ____)
	(No Par ____ Shares)
	Undivided Surplus:
	Earned $ ____
	Unearned ____
TOTAL	TOTAL

*Unless otherwise specifically noted merchandise entered at lower of cost or market.

CONTINGENT LIABILITIES—Upon Trade Acceptances and/or Notes Receivable, Discounted or Sold, $____ Upon Trade Acceptances and/or Notes Receivable, Assigned or Pledged, $____ Upon Customers' Accounts Sold, Assigned or Pledged, $____ Upon Accommodation Paper or Endorsements or upon Notes Exchanged with Others, $____ As Guarantor for Others on Notes, Accounts or Contracts, $____ For Bonds or Unfinished Contracts, $____ Any Other Contingent Liability, $____ TOTAL CONTINGENT LIABILITIES, $____

stockholders or individual or partnership owners, as the case may be. The result is, of course, that the balance sheet balances as its name would imply. In other words, it invariably shows that the assets and liabilities are equal. This is simply a bookkeeping device, however, and has in itself little or no significance.

The assets and liabilities may be arranged in any order that suits the convenience of the business firm making up the statement. But it

is customary to use a certain arrangement of items, partially for convenience, and partially because certain items are more important than others in the analysis of the financial position of the business. One customary arrangement lists, first, the current assets of the business, those assets which, presumably, can be realized upon in a relatively short period of time, or which will result in a speedy inflow of cash into the business. They are then followed by fixed assets, as land, building, and equipment; intangible assets, as good will and patents; and certain other assets, of a bookkeeping character, frequently referred to as deferred charges.

The liabilities under this form of arrangement are listed in the same order: first, the current liabilities, those obligations which must be met in the near future; next, the fixed liabilities, such as bonds and mortgages maturing at a longer period of time; next, the deferred credits, and, finally, the bookkeeping liabilities, representing the net worth or the proprietary interest in the business.

Some statements reverse this order and start with the fixed assets and fixed liabilities. There is little to be said for or against either of these arrangements, but if the statements are to be used as a basis of an application for a bank loan, the first arrangement is preferable, as the bank looks first at the current assets and liabilities in its analysis.

The current assets of a business are frequently referred to as its working capital, some of which may be owned and some borrowed. The difference between current assets and current liabilities would represent the owned working capital of the business. The fixed assets in turn are sometimes referred to as the fixed capital, which in turn may be either owned or borrowed, the extent of either being determined by a consideration of the fixed liabilities.

Balance sheets can seldom be taken at their face value by the bank credit man. Before he can be satisfied that the balance sheet accurately indicates the condition of the business at that moment, he must know the method by which the assets were valued and the likelihood of their having a worth equal to the figures assigned to them. The liabilities do not, as a rule, present a very serious problem. If a liability appears on a balance sheet, it can generally be taken as representing an obligation which will have to be met. In other words, liabilities are seldom exaggerated, the only serious question being whether or not they are all there. In respect to the assets, however, it is not at all uncommon to exaggerate their values and each item must be carefully scrutinized. The balance sheet issued by businesses a few days before their failure will frequently give little indication of the unsound condition of

the business, but will, on the other hand, ordinarily disclose relatively large net worth.

Within the scope of this volume only a very brief indication can be given of the nature of the investigation which should be made of the more important items appearing on a typical balance sheet.

Cash.—While the item of cash appears to require no extended comment, nevertheless the credit department of a bank analyzing the statement will usually wish to be assured that the item appearing opposite this heading actually represents available cash. It is the custom of some business houses, for example, to pay small bills out of cash and carry the vouchers for these payments as a cash item for some period of time. The proprietor of a large baking business in Philadelphia was once accustomed to permit his daughters to draw out small sums from the cash drawer, and place therein their I.O.U.'s for the amounts withdrawn, which would be carried for a considerable period of time as cash items. Temporary withdrawals of cash may be made by partners in a business, leaving only notations in the cash drawer representing the amounts withdrawn.

In addition to verifying the actuality of the cash item, its amount in relation to the size of the business and its character is important. No definite rules as to the proportion of cash a business should maintain can be stated. This proportion varies from business to business and also with the time of year; but the experience of bank officials in dealing with certain types of business over a long period of time will generally reveal a minimum amount of cash which businesses of that character should maintain.

Accounts Receivable.—Sums due and owing to a business currently as a result of its operations bulk fairly large in most business statements. The chief point to be ascertained in respect to these accounts is their relative liquidity and collectibility. For the purpose of determining this, it is essential that the bank should know to what extent these accounts represent customers' accounts, or sums owed by others under conditions which make it unlikely that they will be speedily repaid. The length of time these accounts have been due and owing is an essential matter, for if a large proportion of the accounts are slow or long past due, there is a strong likelihood that many of them will turn out to be uncollectible, or at best that they will not be paid within the period counted on by the bank in making the loan. The bank, of course, looks to the receipt of these accounts receivable as one source of the funds with which the bank loan is to be paid at maturity. Practically all businesses have a certain proportion of bad accounts, and, in a

conservative statement, proper allowance for this should be made by setting up an adequate reserve for such uncollectible items.

A considerable number of businesses raise funds by pledging accounts receivable with commercial credit companies. This fact should be ascertained by the bank, for if the accounts are pledged, they are, of course, not available as a source of funds to retire bank loans. It is true that the amount borrowed on them will appear as a liability, but the actual deduction in the value of the accounts will ordinarily exceed the liability appearing, for the reason that most commercial credit companies require the pledge of accounts in excess of the amount advanced, and this excess, even though collected, is frequently held by the commercial credit companies as additional security for outstanding loans until such time as all of the loans are repaid.

The bank should, of course, ascertain whether the accounts receivable are net or whether items are deductible therefrom in the nature of trade or cash discounts, if paid by the debtors within a given period of time.

Notes Receivable.—Approximately the same analysis must be made of the notes receivable as is made of the accounts receivable, with this additional consideration, that unless the business is one which is accustomed to receive notes for the sale of its merchandise, it is extremely probable that the notes will represent overdue accounts. They are, therefore, less valuable than active accounts receivable. This criticism would not apply to those types of businesses which customarily take notes, but such businesses are relatively few in number.

Of recent years some businesses have made a practice of drawing on their customers for sums due, and such acceptances are ordinarily handled in the same manner as notes and can be properly included under this heading. The statement should disclose whether or not and to what extent the notes and acceptances, or both, have been discounted.

Inventories.—The item of merchandise or inventories presents the most difficult problem to the bank credit investigator. The problem here is one of valuation. In a manufacturing business, the inventories may be in different forms, as, for example, finished product, partially finished product, and raw materials. Even in the case of merchandizing concerns, whose inventories will be practically all finished and ready for sale, the question of determining their value is one of great moment. Depending upon the practices of the business, inventories may be valued at cost or at market price at the time of making the statement, or at cost or market price, whichever is lower; or, in case they wish to deceive, at cost or market price, whichever is higher.

There is no basis for inventory valuation which is proper in all circumstances. The valuation of goods at cost undoubtedly simplifies both the preparation of the statement and the calculation of profits, and would, therefore, naturally be favored by a business man looking at the problem from only the business point of view. The bank, however, is not so much concerned with what the materials cost as with what they are worth, and certainly if they are worth more than they cost there is no reason why the business should not receive the benefit of that difference from the standpoint of analyzing its present financial position as a basis for a loan. Probably the most conservative practice is to value at cost or market, whichever is lower, but this has the obvious disadvantage of forcing, from to time, a change of basis which makes the comparison of successive statements peculiarly difficult, as well as complicating considerably the bookkeepers' problems.

The time of year in which the statement is made up is of importance in considering the inventory item. If the business is highly seasonal, so that at certain times of the year heavy stocks are carried, while at other times the stocks are almost depleted, it is obvious that this factor must be taken into consideration in analyzing the statement. If possible, the statement should reflect the normal state of the business.

The bank will be interested in discovering what proportion of the merchandise inventory is made up of stock which has gone out of style or has depreciated through age, and which can, presumably, only be disposed of at a sacrifice. It may still be carried on the books of the business at cost. It is obviously impossible for a bank to appraise such merchandise itself. In the analysis of the statement the bank must, therefore, rely to a large degree upon the known character and former practices of the applicant, aided in some few cases by independent audits and appraisals by accounting firms.

Fixed Assets.—These assets are generally permanent in their nature and include such items as land, buildings, machinery, furniture, appliances, etc. The same problem here arises as to the method of valuation. In other words, they may be carried at cost, at reproduction cost, at cost less depreciation, or reproduction cost less depreciation. As in the former case there is something to be said for each of these methods of valuation, the important consideration being not which one is used, but that the bank should know which one is used, so as to base its analysis upon that knowledge. It should take into consideration the fact that some of these assets are peculiarly difficult to appraise, and that most of them are worth far more to the business as a going concern than could be obtained for them in the case of a forced

sale. This is also true to some extent of merchandise inventory, but not nearly to the same extent.

A mill may have buildings and fixtures costing it a million dollars, and from the standpoint of earning capacity worth a million, or more, to the mill. If sold, however, at private auction or by the sheriff, the amount obtainable might be relatively insignificant. Again, the question of depreciation allowances is important in this connection. If costs are relatively stationary, there is a tendency for buildings, machinery and appliances to depreciate in value by wearing out. There is a further tendency for them to become obsolete, displaced by more modern inventions and improvements. Adequate allowances for this should be made in the accounts of the business, or at any rate by the bank analyzing the statement. Of course, if building costs or machinery costs are going up, this may offset either wholly or in some degree the physical depreciation of the property. If it cost a million dollars to erect a mill at a given time, and some years later it would cost $1,500,000 to replace it, the actual value of the mill at that later date might be in excess of its cost, although some degree of physical depreciation would have taken place.

The bank, however, is ordinarily not primarily concerned with the liquidation value of the fixed assets. If there is any likelihood that the business will fail and the fixed assets be disposed of at forced sale, the bank will certainly not grant the loan. And furthermore, most businesses involving large fixed assets are reorganized in some form or other rather than subjected to a forced sale. The bank is concerned, however, with such factors as the maintenance of adequate insurance on the fixed assets, their condition as a basis for the continued successful operation of the business, and certain liabilities which may arise out of their possession, which will be more fully discussed under the analysis of the liability side of the statement.

CHAPTER XV

CREDIT ANALYSIS (*Continued*)

LIABILITIES

Although it has been stated that the same degree of difficulty in analysis is not presented by the liabilities as in the case of assets, nevertheless an analysis of the elements of each liability item is necessary for a proper interpretation of the financial position of the business studied.

Current Liabilities.—Current liabilities are so called because they must be met within a relatively short period of time. There is no hard and fast rule as to what that period of time may be, but, generally speaking, all liabilities falling due within a year from the date of the analysis are considered as current. Such liabilities may consist of obligations due on merchandise, or raw materials purchased, whether represented by notes or open accounts; notes payable representing loans from banks or notes sold through note brokers or otherwise; obligations to banks resulting from the discounting of notes or acceptances; obligations to commercial credit companies resulting from the discount of accounts receivable; various expenses of the business such as wages, taxes, interest, etc.; dividends which have been declared but not yet paid; and, finally, obligations arising out of the acquisition of fixed assets, if they fall due within the present fiscal year.

Accounts Payable.—These accounts generally represent the purchase of merchandise and general supplies necessary for the business. It goes without saying that all of the sums due and owing under this heading should be included in the statement. The bank credit man is primarily interested in the relationship which this figure bears to the notes or bills payable. In the case of the normal business, both of these items should not be large, for if the firm buys chiefly upon open book accounts, the amount of notes or acceptances for merchandise should be relatively small. If a considerable number of notes have been given to banks or sold in the open market, the proceeds of this borrowing should be used to reduce the accounts payable. One of the best reasons for bank or open-market borrowing is to take advantage of

cash discounts in the payment of accounts for merchandise purchases, and extensive borrowing by the business not followed by a reduction of accounts payable may indicate a dangerous overextension of credit. If the accounts payable bulk large in the statement, and the bills payable small, this may indicate that the business house is not taking advantage of the possibility of borrowing at the current rate and taking cash discounts at a higher rate. As it is unlikely that the business would overlook this possibility of profit, a further indication is that its credit is not sufficiently good to enable it to obtain loans.

Bills Payable.—The foregoing discussion indicates the nature of the analysis to which the bills-payable item should be subjected. There is this further consideration: the bills payable item should indicate whether the borrowings were from banks or in the open market. Both of these sources of supply should not, under ordinary circumstances, be utilized to a large extent at the same time. If a business house is borrowing extensively in the open market, it should keep free a substantial line of credit with the banks to enable it to borrow from the banks to meet its maturing outstanding notes, if that necessity arises. Obtaining credit in large amounts from all available sources at the same time indicates that credit is being strained and should certainly be a danger signal to a bank in the event of a request for further credit extension. Occasionally there will be found an item of notes or bills payable to others. These items may represent advances to the business by partners, friends, or relations, and may subject the business to the risk of a substantial withdrawal of capital in case these notes are called for payment.

The balance sheet should indicate the degree to which the notes or accounts receivable have been discounted. This should appear as an addition to the liabilities.

Taxes, wages, preferred stock dividends, and interest, which accrue from day to day but are not yet payable, should appear as accrued items and are properly considered as current liabilities because of the assured necessity of making these payments within relatively short periods of time.

Fixed Liabilities.—No extended comment is necessary in respect to the fixed liabilities. They indicate, of course, the extent to which the fixed assets are owned or borrowed, and such long-term obligations as mature within a year should be counted as current liabilities, unless arrangements have been made for their renewal.

Net Worth.—In the case of a corporation, this item includes stock, surplus, and undivided profits. In respect to stock it is advisable to

separate the classes of stock, if more than one class has been issued. The stock is listed at its par value, unless it is a no-par stock, in which case it may be listed at its issue price, or listed at the present value of the surplus. In this case the item of surplus would not appear.

Stock of the company held in the treasury should be listed. It should not be included in the net worth, but handled either as an asset or as a deduction from the outstanding-stock liability of the company.

The total net worth should be carefully scrutinized. It may or may not represent the actual net worth of the business. This fact can only be ascertained by a careful analysis of the assets. The extent to which they have been overvalued would represent, of course, a legitimate deduction from net worth. Many businesses show a large net worth by placing a high valuation upon certain intangible assets such as good will, patents, franchises, etc. Many credit analysts either write down these intangible assets substantially in their interpretation of the statement, or else ignore them entirely, because, although they may be of considerable value to the business itself as a going concern, they may have a negligible value in the event of a forced sale.

INCOME STATEMENT AND RECONCILEMENT OF SURPLUS

The statement on page 198 is a typical blank form of income statement and reconcilement of surplus, as recommended by the Robert Morris Associates.

Unfortunately, there is little standardization in income statements, and many concerns do not publish them at all, reporting simply a single item of gross profit or net earnings, as the case may be. Such statements indicate the success or failure of the business as a going concern over a period of time, and also furnish the basis for an additional analysis of the balance sheets, as the income statement will frequently indicate the sources of the changes appearing in successive balance sheets.

Gross Sales.—This item indicates the total selling price of goods which have been sold before any deductions are made for freight allowances and returns. These deductions are listed separately and result in a figure called *net sales* in the form given for illustration.

The *cost of the goods sold* is ascertained by taking the inventory valuation as of the beginning of the period, adding thereto the cost of the purchases during the period, and deducting therefrom the inventory valuation at the end of the period. The difference between the cost of the goods sold and the net sales represents the *gross profit on*

sales. These calculations are self-explanatory, but care must be taken to ascertain whether or not the sales represent actual sales to customers or only transfers or billings to other departments of the business; and the method of inventory valuation is as essential here as in the consideration of the balance sheet.

The general expenses of the business, and certain other administrative expenses, together with the selling expenses, when deducted from the gross profit on sales show the net profit on sales, which is sometimes called the *profit from operations*.

The company may have other sources of income as, for example, interest on debts due the company, income from investments, subsidiaries, etc., and may have, in turn, other expenses, such as interest on their fixed debts, interest on notes payable, etc. These additions and deductions result in the net income for the period. The disposition of this net income is indicated by showing the dividends paid, if any, and the balance added to surplus, or deducted therefrom, if the result of the operations is a net loss.

Income statements, although of great value in statement analysis, may be very misleading, particularly if proper deductions have not been made. The deductions most frequently omitted or underestimated are deductions for depreciation and obsolescence of fixed or intangible assets. Such omissions are frequently ascertainable by adroit questioning on the part of the banker.

COMPARATIVE STATEMENT ANALYSIS

The chief value of balance sheets and income statements lies not in the analysis of an individual statement, but in the comparison of a series of such statements covering a period of 3 years or more. Such a comparison is known as *comparative statement analysis*, and will be briefly discussed.

The purpose of comparing a succession of balance sheets and income statements of a business is to determine changes in trends in the business. The amounts appearing on the individual statements are large or small only by comparison, and in the comparative statement analysis comparisons alone are of interest.

For the purpose of establishing a mathematical basis for comparison, the bulk amounts in the statements are reduced to percentages. The percentage resulting from the comparison of two bulk amounts is called a *ratio*. It is obvious that almost any number of ratios can be created by comparing any two figures in the balance sheet or income

statement. For the purpose of ratio analysis, some credit writers have established as many as 30 or 40 ratios. Alexander Wall, secretary of the Robert Morris Associates, probably has developed this field as thoroughly as any one, and he has found the following ratios to be more significant than others.

Current Ratio.—The most commonly used ratio of credit analysis is the current ratio, which is ascertained by dividing the total of the current assets by the total of the current liabilities, and reducing it to a percentage by multiplying the result by 100. This ratio indicates the excess of the current assets over current liabilities and is peculiarly important in the analysis of statements as a basis for bank loans, because, out of the current assets, the funds for repaying the loans will presumably come. As there is a tendency for current assets to shrink, either through overvaluation of merchandise inventories, or falling prices, or uncollectible or slow-paying receivables, banks like to see a substantial excess of current assets over current liabilities, in order to amply safeguard against such shrinkage. For many years a rule-of-thumb, minimum-ratio requirement has been 200 per cent or 2 : 1, as it is sometimes stated, indicating that the current assets are at least double the current liabilities. More intelligent analysis developed in the last few years has tended to override this 2 : 1 requirement to some extent, pointing out that there are certain customary current ratios applicable to different types of business, and that, whereas a 2 : 1 ratio might be more than safe in some businesses, in others it might indicate a relatively precarious position.

The bank should consider the current ratio from two points of view: First, is it as high as the ratio generally prevailing in that type of business, and, second, is it declining or rising over the period investigated? Taking the latter question, a company showing a rising current ratio from year to year, even though the present current ratio is less than 200 per cent might be in a stronger position from a credit standpoint than a company showing a ratio of 300 per cent now, but one which had declined over past years from a higher ratio of some time back. Generally speaking, though, and without qualification based upon different types of business, the higher the current ratio, the more liquid the position of the company, and the more likely is its ability to repay its bank loans at maturity.

The current ratio may lose some of its significance, due to the ease with which it can be modified by business or statistical manipulation just prior to the issuing of the statement. For example, if the current assets are $50,000 and the current liabilities are $30,000, this ratio of

166 per cent can be readily converted into a ratio of 200 per cent by the simple process of paying off $10,000 of the liabilities with $10,000 of the assets, as a temporary expedient. The result is that the current assets are $40,000 and the current liabilities $20,000, showing a 200 per cent ratio. This manipulation of statements to give a favorable appearance is sometimes called *window dressing*. It may be checked by the bank credit man by requesting statements from time to time at periods of the year other than those in which the statement is ordinarily published.

The value of the current ratio is, of course, predicated upon the actuality of the figures of current assets and current liabilities which make it up. If the current assets have been exaggerated, cr if the current liabilities do not appear in full, the value of the current ratio is, of course, to that degree vitiated.

The current ratio discloses only the relative quantities of current assets and current liabilities. Other ratios may be utilized to disclose something of the qualities of these assets and liabilities.

Merchandise to Receivables.—A study of the relationship of merchandise to receivables on the asset side of the statement may be used to explain changes in the current ratio. It is customary to value merchandise either at cost or at replacement cost at the market, if that is less than the original cost. This method of valuing inventory does not indicate any profit which may be obtained by the sale of the merchandise, and is a proper conservative method of formulating the statement, because, in the ordinary case, profits should not be shown before the merchandise is sold. If, however, the merchandise is sold, and is thus converted into either accounts or bills receivable, or both, the amount of such receivables corresponding to the amount of merchandise sold will show a higher figure than was carried for the merchandise. In other words, it will show the addition of the gross profit. To take a simple illustration: The inventory is valued at $5,000,000 and there are current liabilities of $2,500,000. This shows a current ratio of 200 per cent, assuming for the moment that merchandise constitutes the sole current asset. If half the merchandise is sold at a price representing a 50 per cent increase over cost, the asset side of the statement will then show merchandise $2,500,000; receivables, $3,750,000; or total current assets of $6,250,000. The current liabilities are unchanged, remaining at $2,500,000, and the current ratio is now 250 per cent. It is true that the business is probably in better condition in that it has succeeded in selling half of its merchandise inventory, but this would not necessarily be the case. In a market of advancing

prices, it might be more profitable to hold the inventory than to sell it. The conversion of merchandise into inventory would, therefore, normally result in a rise in the current ratio. If it does not, it indicates either that the merchandise is not being sold at a gross profit, or that the business is adding debts to its current liabilities at a rate sufficient to offset the increase in current assets. This would give rise to a situation which the credit investigator would wish explained. Of course, the reverse situation is true also. If there is a declining ratio of receivables to merchandise, there would normally be a declining current ratio. If this decline does not occur, it may indicate that the merchandise is being valued at more than cost. This ratio may indicate an overinventoried condition or a condition in which too small an inventory is carried to meet the probable current needs of the business.

The credit investigator will seek to discover whether or not the conversion of merchandise into receivables is the result of actual sales or simply the billing of merchandise to agencies at the higher sales price. This latter practice might be adopted in order to increase the current ratio. Such an increase would, of course, be highly fictitious.

It is evident that a study of the relationship of merchandise to receivables will go far in explaining increases or decreases in the current ratio and perhaps also the apparent significance of such changes.

Net Worth to Debt.—The bank is interested in discovering the extent to which the capital of the business is either owned by the proprietors or borrowed. If the debts of the business equal the net worth, that would indicate that half of the capital of the business had been contributed by the proprietors and half by creditors of the business. There is no particular significance in this ratio by itself, except as it may be out of line with a similar ratio in like businesses. But it is significant in its movements from year to year. If the ratio of net worth to debt is declining, it indicates that the business is relying for its increases in capital primarily upon creditors, and that the owned capital of the business, in a sense a guaranty fund for the protection of creditors is becoming smaller and smaller in relation to the magnitude of the operations. On the other hand, an increase in net ratio would indicate that the creditors were better protected by a relatively larger contribution of capital on the part of the proprietors.

It is of further interest in analyzing the significance of this ratio to note the character of the debt, the extent to which it is funded, and the extent to which it is current or short-time. It is fairly obvious that a relative increase in the current debt involves more risk to creditors than a similar increase of funded debt, which is presumably amply

secured by fixed capital and will not fall due for some considerable period of time. In fact, the creditors who have advanced the funded debt are almost in the position of additional partners.

Net Worth to Fixed Assets.—It goes without saying that in the analysis of this ratio, as of the others mentioned, due consideration must be given to the seasonal activities of the business analyzed. In most businesses it is inadvisable to utilize funds procured from short-term notes or other obligations of indebtedness for fixed-capital improvements. Fixed-capital additions should ordinarily be financed by funded-debt obligations, or by the original contributions of capital on the part of the proprietors. A study, therefore, of the relationship between net worth and fixed assets would indicate what part of the proprietor's funds are available for current assets after the fixed assets have been financed. An increase in the net worth of a business is ordinarily an indication of increased security from a creditor's standpoint, and ordinarily means that the business has been making substantial profits and has reinvested a proportion of those profits in the business. If, however, an increasing part of the profits is being utilized to add to the fixed assets—which would be indicated by a declining ratio of net worth to fixed assets—it may indicate that the plant is being increased in size too rapidly. A period of business depression or falling prices would then result in severe financial difficulties to the business, due to the increased relative cost of carrying and paying interest upon debts arising out of the overexpanded plant additions. It will mean that the company has converted a considerable proportion of its current assets into fixed assets and is in a less liquid situation. This condition was particularly serious in the period just prior to 1920, when many businesses, encouraged by the long period of rising prices and a high degree of business activity which culminated in 1920, overexpanded their fixed assets in anticipation of a continued increase in prices or business, or both, which did not materialize.

The preceding ratios may all be prepared from a study of the balance sheets alone. They represent only a few of the many ratios which may be established in the analysis of successive balance sheets and should be used chiefly to indicate the nature of such an analysis. The practical experience of bank credit men should disclose to them the possibility of adding to these ratios by the study of other relationships which will throw additional light upon the condition of the business. In other words, these ratios are in no sense exclusive, but are primarily suggestive in their nature. Other valuable ratios may be

constructed and analyzed, using as their basis a comparison of figures appearing in the balance sheets and income statements. The income-statement figure of most significance in the construction of such ratios is that of sales.

Sales to Receivables.—In the analysis of items appearing on a statement, it has been suggested that the item of receivables should be investigated, to determine the extent to which they represent stale or long-overdue accounts. If a business sells on 30-day terms, then the receivables should be paid off at the end of 30 days. There are 12 such periods of 30 days in a year, and, therefore, in normal times the annual sales should be about twelve times the average of receivables. If the annual sales amounted to six times the receivables item, it would indicate that instead of paying in 30 days, the bulk of the purchasers were extending their period of payment to 60 days. If, in analyzing a series of statements over successive years, the sales-to-receivables ratio remains fairly constant it would indicate that the company was not accumulating a mass of overdue accounts. On the other hand, if the ratio were decreasing, it would indicate either that such overdue accounts were increasing in bulk, or that the company had altered its terms of sale. The latter fact could be readily ascertained by questioning the officials of the company and if no change in the terms of sale had taken place, a decline in the sales-to-receivables ratio would indicate a less liquid condition and throw some doubt upon the total value of the receivables item.

Sales to Merchandise.—This ratio indicates the turnover of the merchandise inventory. If the annual sales are twelve times the inventory carried, it would indicate a turnover of merchandise inventory of about once a month. Due consideration must be given to the fact that merchandise is carried probably at cost, while the sales item represents an addition of gross profit, and therefore a sales-to-merchandise ratio of 1,200 per cent would indicate a turnover of something less than twelve times a year. A declining ratio may indicate that the merchandise is harder to move, or that the company is in an over-inventoried condition. Any continued holding over a long period of time of inventory increases the risk of the business from a creditor's standpoint. On the other hand, if the ratio is too high, it may indicate that the business is not carrying an adequate inventory for its needs and that it is running the risk of tie-ups in adding to its inventory, or inability to acquire goods to meet outstanding contracts. The significance of this ratio, as of the others mentioned, varies, of course, with the type, character, and seasonal activity of the businesses studied.

Sales to Net Worth.—The profit of a business is largely predicated upon the activity with which the proprietor's capital is utilized. This can be determined to some extent by comparing the annual sales figures with the net worth of the business. A rising ratio of sales to net worth would indicate increased activity of the proprietor's capital, and, provided that this was not excessive or out of line with the normal conditions of that industry, would show a favorable condition from the credit analyst's standpoint. On the other hand, a declining ratio would show that the proprietor's funds were being less actively employed.

Sales to Fixed Assets.—As in the preceding ratio of sales to net worth, this ratio indicates the activity with which the plant or fixed assets of the business are being employed. A rising ratio of sales to fixed assets would indicate a more active and presumably more profitable utilization of the existing plant, and a declining ratio would show the reverse.

In all the ratios utilizing sales as one element in the computation, but particularly in respect to this last ratio, changes in price must be taken into consideration in evaluating the ratio figures reached. Increases in prices automatically result, other things being equal, in increases in the sales figure, as sales are reported in terms of dollars and cents rather than in units of commodity dealt in. As it is not customary for businesses to write up the value of their fixed assets proportionately to increases in current price levels, an increasing ratio of sales to fixed assets may not, as a matter of fact, show a higher utilization of the fixed assets. It may not indicate that any more units of the commodity are being sold, but may result solely from an increase in the price of the units dealt in. To that extent an increase in net ratio would be less significant than if it occurred during a period of relatively stationary prices. This price factor must enter into the interpretation of all the ratios which have been suggested. Certain ratios will be normal in certain businesses, for periods of business activity termed the *prosperity period* of a cycle, while other ratios would be normal for periods of relative business depression. The cyclical changes of business activity must then be given due weight in the interpretation of these or other ratios which may be constructed. Again, it is to be emphasized that numerous other ratios utilizing the sales figure may be computed. The ones suggested are simply indicative of the process to be used and the nature of the conclusions which may be drawn from it.

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CHAPTER XVI

THE CLEARING AND COLLECTION OF CHECKS

It is a matter of common knowledge that a very large proportion of the business in the United States is financed by means of deposit, or check, currency, rather than through the use of bank notes, gold, or other forms of cash currency. Checks, unlike bank notes and other forms of cash currency, do not continue to circulate, once issued, but must be returned to the bank on which they are drawn for payment, even though this bank may be far distant from the place of residence of the payee. This situation has necessitated the development of an efficient system for the clearing and collection of checks.

Checks, unlike most notes and other time items which a bank receives in the course of the day's work, are payable at sight. Individual banks have created separate departments, usually designated *Transit* or *Check Collection* departments, in order to carry on more effectively the operations necessary in clearing and collecting checks. Elaborate machinery has been built up for the purpose of keeping at a minimum the *float* or funds tied up in checks in the process of collection, and numerous methods have been adopted for assisting in this work. At the present time, in this country, checks are cleared through the following agencies:

1. Local clearing houses operated by banks in the larger cities.
2. Correspondent-bank clearing.
3. Messenger clearing, or the presentation of checks for collection through messenger service.
4. Direct-mail clearing.
5. Federal Reserve banks, clearing for the member and certain other banks within their respective districts. Interdistrict clearing operations are settled through the Gold Settlement Fund operated by the Federal Reserve Board at Washington.

Clearing Houses.—A clearing house is an association of banks for the purpose of clearing or settling their claims against each other. It is also the place where the clearing is done. Briefly, the purpose of clearing is to reduce the quantity of money necessary to pay checks, by permitting debits and credits to be canceled against each other, so

that differences only need be paid. If a bank, a member of a clearing-house association, receives in the course of a day's business $1,000,000 of checks on other banks, members of the clearing house, and these other banks receive $1,050,000 of checks drawn against it, the process of clearing will enable all of these checks to be settled by the payment of $50,000 to the clearing house. This bank has a debit balance, while other banks will have credit balances and receive funds.

Clearing houses exist in most of the larger cities. Their quarters are usually rented rooms centrally located, or the member banks themselves rotate in furnishing space. The New York Clearing House owns its own building. An association usually has a president, vice-president, secretary, treasurer, manager, and an executive committee. The latter committee formulates the policies of the organization.

A clearing house, in addition to facilitating the settlement of balances between members, renders other services to the banking community by adopting rules and regulations concerning certain of the operations of its members. These mainly relate to reserves, loans, advertising practices and the like. This tends to develop uniform practice among the institutions serving a community, and helps to eliminate reckless competitive banking. Frequently, the clearing house employs examiners, who make periodic investigations of the member institutions. The work of the clearing house in a large center will be divided among several departments, which are usually designated the city department, the city collection department, the examination department, etc.

Procedure in Clearing.—Each bank prepares, in separate packages for each clearing bank, the checks for the clearing house, and places them on the assembly rack. A slip showing the total amount contained in each package accompanies the packages. These checks are then sent to the clearing house in time for the appointed opening, which occurs usually in the early forenoon. Each of the banks is represented at the clearing house by two clerks, the delivery clerk and the settling clerk. The settling clerks representing the several banks are seated at desks, while the delivery clerks form in line, and, at a signal given by the manager of the clearing house, pass before the desks of the settling clerks, depositing the appropriate package with each settling clerk who receipts for the package. The delivery clerk then takes back to his bank the packages which have been deposited with their representative, while the settling clerk remains to help prove the transactions. Balances might be settled by the use of cash or of clearing-house certificates, manager's check, or by a draft drawn on some designated city

institution. A common practice in those cities in which a Federal Reserve bank is located, is to settle by book entries with the Federal Reserve bank. A description of this latter method follows in the section devoted to the work of the Transit Department of the Philadelphia Federal Reserve Bank.

With the establishment in 1899 by the Boston clearing house of a country collection department, country clearing-house collections were inaugurated in this country, but the establishment of the clearing operations of the Federal Reserve banks did away with the need for country clearing houses.

Correspondent Bank Clearing.—The unit banking system as developed in this country, and the lack of central banking facilities prior to 1914 have been largely responsible for the wide use of correspondent banks in the collection of checks. Before 1914, the circuitous routing of items, due to the use of correspondent banks and to the desire to avoid collection charges, often resulted in an extremely large volume of *float,* which was expensive and slowed up check collections. Today, because of the clearing operations of the Federal Reserve banks, the volume of *float* has been reduced substantially. Correspondent banks are still used in collecting items, because in some cases checks may be cleared more rapidly by sending them to a correspondent rather than utilizing the Reserve bank. Thus if the X National Bank of Scranton has a check drawn on the Y National Bank of Philadelphia, and has a correspondent bank in Philadelphia, it may receive credit one day earlier by sending the check for collection to its correspondent bank rather than to the Federal Reserve Bank of Philadelphia. Correspondent banks are utilized by the banks which are neither members nor clearing members of the Federal Reserve System, and even members of the system may clear through correspondents for the purpose of building up their balances with the correspondent banks.

A city bank regards items deposited with it and payable outside the city limits as *foreign* items. This, in some cases, applies to items payable in the outskirts of the city. These foreign items usually consist of co-called transit items and collection items. Transit items are regarded as cash items and given immediate credit, while collection items are received for collection only and are credited after the collection has been made. After the check has been presented for payment, the correspondent bank credits the account of the institution sending it the check for collection. It is willing to render this service because it thereby increases its deposits, and in large cities the accounts of smaller banks are much sought after by the urban institutions.

Messenger Clearing.—A bank located in a city has deposited with it checks drawn on institutions in the city not clearing through the clearing house, and frequently drafts representing large sums drawn on both clearing and non-clearing-house banks. Such items are collected by messengers, who are attached to the collection department. It is usually the custom to assign these messengers to definite routes. Remittances, representing the checks presented by the messengers, usually are in cash.

Direct-mail Clearing.—To some extent, the practice of mailing items direct to the drawee bank is still in vogue in this country. It is done when a bank has no correspondent through which it can conveniently clear items, or if it is thought that collection will be hastened by mailing the item direct. Remittances, in such cases, are usually drafts drawn upon correspondent banks located in the larger cities, particularly those located in New York City.

Clearance of Checks by Federal Reserve Banks.—For purposes of illustration of the actual methods for the clearance of checks, by Federal Reserve banks, the work of the Transit Department of the Philadelphia Federal Reserve Bank will be described briefly. This bank clears checks for all member banks located in the Philadelphia Federal Reserve District, for non-member clearing banks, for other Federal Reserve banks, and their branches, and for member and non-member clearing banks in other Federal Reserve districts which have received the direct sending privilege. This last group consists of banks which have, each day, sufficient checks drawn on points within the Philadelphia district to make it desirable for them to send their checks on this district direct to the Philadelphia Federal Reserve Bank, instead of sending them through the Federal Reserve Bank of their own district, which would both require more time, and more expense in handling. The *non-member clearing banks* are banks which are not members of the Federal Reserve System, but do carry an account, and have arrangements with the Federal Reserve bank for the clearing and collection of checks only.

Each Federal Reserve bank also forwards checks direct to banks in its district which, although not members of the Federal Reserve System, have agreed to remit at par for checks drawn on them and so forwarded. These banks do not, however, send any checks to the Federal Reserve bank for collection, but remit only in cash, or satisfactory exchange drawn on a correspondent.

The Mail Desk.—Everything coming into the Transit Department originates at the mail desk or check-deposit window. Member banks

within the city limits leave their checks at the check-deposit window, while those outside of the city use the mails of course. Envelopes bearing distinguishing marks are provided the bank's out-of-town correspondents, so that the sorting of the mail into sections can be done to a large extent before opening it. At the mail table, the mail is sorted geographically as well as by the name of the bank from which it originated. Thus, the mail from one group of correspondents is sorted as follows:

1. From towns in Delaware, New Jersey, and those in Pennsylvania beginning with A
2. From Pennsylvania towns, B to I
3. From Pennsylvania towns, J to Q
4. From Pennsylvania towns, R to Z
5. From other Federal Reserve districts.

After this process, the envelopes are opened, and the *city* checks are segregated from *country* checks. For example, all checks drawn on banks in Philadelphia and Camden will be separated from checks drawn on banks outside these two cities.

Grouping of City Checks.—After the city checks have been segregated, they are grouped into bundles known as *batches*, each composed of about 500 checks, in order to localize errors and speed up settlement. The checks are listed by adding machine on large sheets which are themselves referred to as *batch sheets*. All the checks in a batch will be sorted into divisions. These divisions are each composed of a suitable group of banks which experience has shown will receive a sufficient volume of checks daily to form a convenient unit for a settlement figure.

The checks are then removed from the rack, indorsed by a machine somewhat similar to a canceling machine used by the post office, and are sorted by clerks into pigeonholes, the division being made according to the banks on which they are drawn, and to which they will be presented for payment.

As the checks to be presented to a given bank accumulate, they are listed on a *letter*, one of these letters being prepared for each bank. The checks, with the letters, are then placed in an envelope marked with the bank's name. A great deal of this work is carried on by evening and night forces, so that the work will be finished when the clearing hour approaches, which is 10:00 a.m. in Philadelphia. The Federal Reserve Bank of Philadelphia is a member of the Philadelphia Clearing House, and presents and receives checks for payment through

it, in the same manner as the other members. The Federal Reserve bank also assists in the settlement of the clearing-house balances, as described in a later paragraph.

By a quarter of ten, usually, the last checks are placed in the envelopes, and the grand total arrived at for each bank is entered on the outside. These grand totals are likewise entered on the clearing-house settlement sheet, a sheet containing the names of the members of the clearing house, the amount of checks on each bank being entered opposite that bank's name. A separate sheet is prepared in a similar manner for certain banks and trust companies which receive checks through the clearing house, but bring no checks to it.

The sum total of the checks going to the clearing house must agree with the sum total of city checks received. The latter figure is computed by making a recapitulation of the *batches* or sheets on which the checks were originally listed immediately after sorting. Such a settlement is made two or three times during the night in order to avoid last-minute confusion and delay.

The Process at the Clearing House.—At the clearing house, the messenger of the Federal Reserve bank presents each envelope to the representative of the proper bank, and that representative receipts for it on the clearing-house sheet mentioned above. The messenger will likewise receive from the representatives of the other banks checks on the Federal Reserve bank and will receipt for them.

The manager of the clearing house will then figure the amount or balance due to or due from each member of the clearing house, and settlement will be made later in the day. As a general rule the Federal Reserve Bank will always have a credit balance, while the other banks will have a debit balance at the clearing. The manager of the clearing house will then certify to the Federal Reserve Bank the amount owed the clearing house by each member of the clearing house which is also a member of the Federal Reserve System; or the amount due to the bank, if there should be any due. The Federal Reserve Bank will then debit the various banks on its books for the amount they owe the clearing house, and credit itself and any other banks having a credit balance for the amount due.

Trust Company Clearing.—A large number of trust companies and state banks have agreed to receive items drawn upon them at the clearing house. This is a separate settlement, these banks do not present any items drawn on other banks. The packages are presented by members of the Clearing House Association, and listed on a sheet similar to the one used in the regular clearings, and receipts are taken

for each package surrendered by the banks which bring such packages to the clearing house. Members of the Clearing House Association receive a check from the clearing house for the total of all items they present. This check is to be presented the day following its receipt in the regular clearing in a package addressed and charged to the clearing house, which maintains a desk in the regular clearing. The trust companies in payment of the checks they receive pay the clearing house with drafts drawn on their depository banks. They have deposited collateral with the Clearing House Association in various amounts. Should the total of their debt be more than the amount of collateral deposited, they issue two drafts drawn on their depository banks; one the equal of the amount of collateral deposited, and the other equaling the amount by which their debt exceeds the amount of their collateral deposited. This check, for the amount by which their debt exceeds their collateral deposit, is required by the clearing house to be certified. The Clearing House Association receives these drafts from the trust companies in payment of debit balances, holds them over night, and presents them the next day through the regular clearing to the banks on whom they are drawn.

It will be noted that the clearing hour is not until ten o'clock in the morning, and in order to expedite their work, some of the banks in the city will have their messengers call at the Federal Reserve bank to get checks which may be ready for them, the messengers calling around eight o'clock in the morning and giving formal receipt for the checks. These receipts represent the checks thus taken up in the package which later goes to the clearing house, so that settlement is made through the clearing house. The checks, themselves, are not held up until the clearing hour, and thus the work of the banks is speeded up.

Checks on "Run" Banks.—Of course, not all the banks in the city are members of the clearing house, and checks on such institutions must be presented by messengers. This is the significance of the *run* classification mentioned in connection with the sorting of checks on banks within the city.

The checks which the Federal Reserve bank has on these so-called *run* banks are taken from the rack, indorsed, and sorted according to banks in a manner similar to those being prepared for the clearing house, and letters are prepared listing the checks on each bank. The grand totals thus secured are entered opposite the name of each bank on the run sheets, there being one of these sheets for each section of the city.

Following is an example of a *run sheet*:

Metropolitan Trust Co.
Drovers and Merchants National Bank
Penn Colony Trust Co.
Belmont Trust Co.
Woodland Avenue State Bank
Cobbs Creek Title and Trust Co.
William Penn Title and Trust Co.
Market Street Title and Trust Co.
Manufacturers Title and Trust Co.
Overbrook National Bank
Empire Title and Trust Co.
Lancaster Ave. Title and Trust Co.
63rd Street Title and Trust Co.

West Philadelphia Run Date:

Runner...............

A settlement of these is likewise obtained by comparing the total of these outgoing letters with the total of checks received from the mail table as shown by the *batches*.

The letters having been prepared for the *run* banks, they are sent out to the banks by automobile, or by messenger, in the case of banks in the immediate vicinity. In Philadelphia, two runs are made, one at seven in the morning, and another at eleven o'clock in the morning, the checks being left at each bank. At the conclusion of the eleven o'clock run, the *runners* return on the same route, and again call at each bank, at which time they receive a draft in payment for the checks presented in the course of the two runs at seven and eleven o'clock, less items returned unpaid. By thus collecting after the second run, the last bank on the second run is not unduly delayed in the receipt of its checks.

Checks Received.—Packages received by the Federal Reserve Bank from the clearing house are taken care of at the *settlement desk*. Here they are split down or sorted, *run on* or listed, totaled and settled, and sent to the check teller or paying teller for payment. They are examined by the latter department and sent to the bookkeepers for charging to the proper accounts.

Checks drawn on banks located in other cities and towns are likewise sorted into sections corresponding to the arrangement of the ledgers, and are listed on the large sheets referred to as *batches*, only the sheets are of a different color to distinguish them from the sheets on which checks drawn on banks within the city are listed. The

checks having been thus *run on* and the totals proved against the totals of the letters which accompanied them from the banks which sent them in, the checks are thrown into a rack according to the sections referred to previously.

From the rack they are then indorsed and taken to other racks, divided according to the banks on which they are drawn, and the outgoing letters are prepared. Printed form letters are used on which have been entered, by an addressograph or similar machine, the name and address of the bank to which the checks are to be sent, there being a letter for every bank. The clerks then take the checks and list them on these letters by adding machine, the transit numbers of the preceding indorser being entered opposite checks of $500 and over for reference in case the check is protested for non-payment, or if other difficulties arise. The bank, of course, keeps a carbon copy of each letter, and the original together with the checks will be placed in an envelope and will go to the mailing room to be stamped and sent out.

Recently, the Philadelphia Federal Reserve Bank has installed *Recordaks* which take photographs of certain checks passing through the bank, the photographs being made on a compact reel, 8,000 checks to 100 feet, enabling the bank to retain a photographic record of the checks in a small filing space. At present the Federal Reserve Bank of Philadelphia retains picture records of:

1. Checks going to certain other Federal Reserve districts.
2. The back (indorsement) of checks in excess of $500 drawn on other Federal Reserve districts.
3. Checks drawn by the Treasury Department of the United States.

Complete and accurate information is thus available in case of the loss of the checks or other irregularities.

The Treatment of the Letters.—As yet the letters coming from the various banks which sent the checks in have not been accounted for. The totals of the amounts entered in these letters are placed on the batches on which the checks themselves were listed after having been sorted the first time. By thus comparing the total of this sum with the total of the checks, a first proof is obtained. From these letters lists are then prepared for the bookkeepers, and the total of these lists must likewise agree with the total of the checks and the total of the amounts appearing in the letters. There is thus a triple proof on the incoming items. The lists and the letters then go to the bookkeeping department, where appropriate credits are made to the accounts of the banks sending in the checks, and the accounts of banks to which the

checks are sent for collection and payment will likewise be charged the proper amount by the bookkeeping department, thus reducing the clearing process to a matter of bookkeeping. Both the debits and the credits, however, are actually deferred in accordance with the scheduled mail time required for the checks to reach the banks on which they are drawn. The manner in which the checks on banks in other Federal Reserve districts are paid will be discussed later.

Settlement and Proof.—The heart of the department is, of course, the settlement desk, for everything must prove against everything else or something is wrong, and the error must be located. Two settlements are made a day, the earlier one being referred to as the A.M. settlement and the later one as the P.M. settlement. They are alike, however, and are for similar purposes.

So far as the settlement of the checks is concerned, a grand total of the incoming items is arrived at by making a recapitulation of the various batches, this being done by sections. A similar total is obtained from the outgoing letters giving the total of outgoing items, and these two figures must agree. In order to handle items coming from other departments of the bank, a batch is made up for them and they are put through just as if they came in the mail; the settlement is thus made to balance.

Everything coming into the department and everything going out of the department must be represented on the Division Proof Sheet. The settlement clerk charges each department of the bank with everything sent to it, and credits each department with everything sent by that department to the Check Collection Department. These entries are made in total on the proof sheet, and the total of incoming items must agree with the total of outgoing items. As a further check, the figures are compared by telephone with each other department in the bank, in order to see that the Check Collection Department has been charged with what it has credited to each of the other departments, and *vice versa.* Errors are thus avoided, and the task of the department making the general settlement for the entire bank is lessened.

Return Items.—Of the checks sent out for collection and payment, a certain number will, of course, come back for one reason or another. For the handling of these checks, a subdepartment of the Transit Division, known as the *Return Item Department*, is maintained. All items returned are sorted out at the mail table, and go direct to the Return Item Department. Here they are examined for reasons, and letters are prepared sending them back to the bank where they originated, or whence the Federal Reserve Bank received them. Re-

turn items to be returned to banks in other Federal Reserve districts are sent directly to the member bank, the Federal Reserve bank of that district receiving a copy of the letter, to be used as a basis for charging the member's account. This procedure prevents unnecessary delay. In the case of items of $500 and over, the bank or indorser is notified by wire, thus enabling them to notify their depositor even before they have the item, and making prompt action possible.

Credits, Charges, and Remittances.—At this point it might be well to discuss the method of payment for items. Checks received to be collected are of course credited to the account of the bank sending in the checks. However, the *availability* of this credit varies with the point on which the checks are drawn, those on Philadelphia received in time for the clearing house being available immediately, for instance, and those on more distant points being available only after a certain number of days, depending upon the time actually required for mail to reach the bank on which the checks are drawn. By *availability* is meant the number of days which must elapse before the bank can draw against the credit created by the deposit of the checks for collection. As previously mentioned, debits to banks' accounts for checks sent them for payment are similarly deferred until the checks have had time to reach the banks and a remittance draft or authorization received to charge the receiving bank's account.

Outgoing checks being sent to banks not carrying an account with the Federal Reserve bank obviously cannot be charged to the drawee on the ledgers. Amounts due from these banks are either remitted for in currency or by draft on an acceptable exchange center.

Checks on Other Districts.—In the collection of checks, a Federal Reserve bank of one district has no relations with any other than a Federal Reserve bank or branch in another district, except in the matter of return items, which are returned direct. Checks on banks in other districts, *in so far as settlement is concerned*, are handled as if payable at the other Federal Reserve bank. Transactions involving checks on banks generally in other districts lose therefore all identity as far as *drawee banks* are concerned.

Gold Settlement Fund.—As is well understood, member banks of the Federal Reserve System and certain *non-member clearing banks* carry accounts with the Federal Reserve banks in their respective districts. If a Federal Reserve bank has a check drawn on a bank in another district, the check will be collected through the Federal Reserve bank of that district. Balances between the various Federal Reserve banks are thus created, and for the settlement of these balances the

Gold Settlement Fund was established. Each of the 12 Federal Reserve banks has deposited gold with the Federal Reserve Board in Washington, the gold itself being kept in the vaults of the Treasury Department. A Federal Reserve bank segregates its transactions with each of the other Federal Reserve banks into two accounts, one for its own business and the other for the other bank's business. Each day a total of the gross credits for the other bank's business is wired to the Federal Reserve Board, and the resulting net debit or net credit for each bank is made in its account in the Gold Settlement Fund.

To illustrate the method of operation of the Gold Settlement Fund, one might take a hypothetical case of a customer of the X National Bank of Philadelphia, depositing a check drawn on the Mercantile National Bank of San Francisco, Cal. The X National Bank of Philadelphia would send this check for collection to the Philadelphia Federal Reserve Bank. The check would then be mailed to the San Francisco Federal Reserve Bank, and the Gold Settlement Fund at Washington would be notified by wire upon the arrival of the check at San Francisco. The account of the Philadelphia Federal Reserve Bank would be credited with the amount of the check, while the San Francisco Federal Reserve Bank would be debited. In view of the fact that the Gold Settlement Fund is kept in the Treasury Department at Washington, the settlement of the transaction would amount to a mere bookkeeping transaction, as it would be unnecessary to change the location of the gold. The X National Bank of Philadelphia would then be credited by the Philadelphia Federal Reserve Bank for the face of the check. In order to simplify such an operation, a time schedule has been worked out which fixes the period elapsing from the time an outside check has been presented for clearing and when the payee bank is to be credited by the Federal Reserve bank.

The Volume of Business.—In order to give some conception of the volume of business which must be handled every day, it might be interesting to note a few details concerning the Federal Reserve Bank of Philadelphia. This bank handles about 350,000 checks a day, the dollar value of which runs between $85,000,000 and $90,000,000 a day. During the year 1928, 64,485,100 checks, aggregating $28,599,278,223, were handled. The record day for check collection at the Philadelphia Reserve Bank was Nov. 12, 1927, the day after Armistice Day, when 457,824 checks were handled, aggregating $112,571,728.10. To handle this volume of business, 12,000 square feet of floor space, 157 adding machines, and a staff of about 225 people are needed. Of the staff, about 14 work on the twilight force from 6:00 p.m. to 1:00 a.m.;

about 55 on the night force, from 1:00 a.m. to 9:00 a.m.; and the balance during the day. The work is so arranged, however, that the shifts overlap and they do not all change at once, thus preventing any break in the work.

The Par Remittance Controversy.—A certain amount of expense for the drawee bank arises in making remittances when a check is presented for payment by methods other than over the counter. This expense may be charged to the account of the drawer of the check, or an amount may be deducted from the face and the reduced sum remitted. This is sometimes called an *exchange charge.* In this connection, a practice developed whereby drawee banks would charge more than the cost of remitting, in order to make a profit out of the transaction. In certain sections of the United States, small rural institutions made a substantial part of their profits from remitting below par.

The Federal Reserve Act as amended has certain provisions, incorporated within it, for the purpose of facilitating the clearing and collection of checks. It was the early desire of the Reserve authorities to gradually bring about a situation where all checks would be redeemed at face value, and thus do away with the obnoxious exchange charges. In doing this, the Reserve banks, as stated elsewhere, arrange to clear for *non-member clearing banks*, as well as for member banks. They also forward checks direct to banks which do not come within the above classifications but which have agreed to remit at par for checks drawn on them and so forwarded. In some of the Reserve districts, pressure was applied to those banks which would not cooperate with the Reserve authorities. In some cases, the Reserve authorities had express companies present checks for payment over the counter in order to force *hold off* banks to cooperate with the system. Opposition to the Reserve banks' activities started to grow and attempts were made to restrain Reserve banks from applying pressure in their efforts to force par remittances; state legislatures were influenced to pass legislation upholding exchange charges. In addition, an attempt was made by legal process to restrain the Reserve banks from forcing par collections. This led to bitter legal battles, which were finally carried to the Supreme Court of the United States. In June, 1923, a momentous decision was made by that body in a case testing the constitutionality of a statute passed by the legislature of North Carolina to legally authorize state banks and trust companies to charge exchange and to refuse to remit in cash when checks were presented by the Reserve banks or their agents. The Supreme Court sustained the act. The Federal Reserve Board then adopted new regulations regarding the

collection of checks drawn upon non-par remitting banks, and all efforts to force banks to join the par list by methods other than persuasion have been abandoned. These regulations are as follows:

Section III. Checks Received for Collection

1. Each Federal Reserve bank will receive at par from its member banks and from non-member clearing banks in its district, checks[1] drawn on all member and non-member clearing banks, and checks drawn on all other non-member banks which are collectible at par in funds acceptable to the Federal Reserve bank of the district in which such non-member banks are located.

2. Each Federal Reserve bank will receive at par from other Federal Reserve banks, and from all member and non-member clearing banks in other Federal Reserve districts which are authorized to route direct for the credit of their respective Federal Reserve banks, checks drawn on all member and non-member clearing banks of its district, and checks drawn on all other non-member banks of its district which are collectible at par in funds acceptable to the collecting Federal Reserve bank.

3. No Federal Reserve bank shall receive on deposit or for collection any check drawn on any non-member bank which cannot be collected at par in funds acceptable to the Federal Reserve bank of the district in which such non-member bank is located.

References

Cannon, James G.: "Clearing Houses," Publication of the National Monetary Commission.

Westerfield, Ray B.: "Banking Principles and Practice," Chaps. XXVI and XXVII.

Willis and Steiner: "Federal Research Banking Practice," Chap. XX.

[1] A check is generally defined as a draft or order upon a bank or banking house, purporting to be drawn upon a deposit of funds, for the payment at all events of a certain sum of money to the order of a certain person therein named, or to him or his order, or to bearer, and payable on demand.

CHAPTER XVII

BOOKKEEPING, AUDITING, AND DEPOSIT ANALYSIS DEPARTMENTS

Bookkeeping Department.—The importance of banking institutions in the modern scheme of economic life and the reliance which business and non-business activities must place upon the proper functioning of the banking system which serves them have made it more necessary for banking institutions to keep accurate records than for the average commercial enterprise. The state has recognized this need for accurate accounting methods on the part of the banking institutions by not only supervising the accounts of the banks through periodic examination, but, in addition, by suggesting and recommending new and improved methods by which banking institutions may better their accounting systems.

If a business is to function effectively for any period of time, it is necessary that the managers of the enterprise at all times be informed of the standing of the concern. These records cannot be kept in a slipshod and loose fashion, but must be kept by a methodical, accurate, and efficient system of bookkeeping. One finds, therefore, that the successful business enterprise devotes considerable expense and energy to the creation and operation of a bookkeeping department. There are several large concerns in this country which devote their entire energies towards devising, manufacturing, and selling equipment and machinery for enabling bookkeeping departments to function more effectively.

The benefits to the proprietors of a business of a sound bookkeeping system are manifold. It enables them to know accurately the results of their labors. It shows the status at any one time of the concern, and it demonstrates the effectiveness of the management. All banks have more or less of a bookkeeping department. The smaller rural institutions cannot afford, nor do they need, an elaborate and separate bookkeeping department. There, the books can be kept by a small clerical staff. The large urban institutions, on the other hand, require

the service of a department whose functions are merely to keep the records of the business done. These bookkeeping departments become more elaborate as the size of the institution increases. With the tendency in many of the large cities and states towards branch banking, it becomes evident that larger departments will be required to keep accurately the records of the business of the several branches of a bank. In many cases where branch banking is practiced, it is found desirable to have the bookkeeping department operate in the parent office for all the branches.

There cannot be too great a diversity of accounting practice among the banks, because of the frequent examinations made by examining bodies of the government or other authorities. In order that the work of the examination force may be facilitated, it becomes necessary that a certain amount of uniformity in practice exist among the banks to be examined. Then, again, the work of the concerns previously mentioned, which specialize in the development of efficient systems, tends to create a uniformity of bookkeeping practice among the banks.

It is possible to generally divide the books kept by any bank into two general groups: first, that group concerned with the corporate records which include the minute book, the stock ledger, the stock certificate book, and the stock transfer book; and, second, the financial records of the institutions which are kept by the bookkeeping department. The recording in the corporate records is not usually a function of the bookkeeping department and as it does not differ to any degree from the methods employed by corporations other than banks, it will not be discussed further in this section.

The financial records of a bank consist of the books of original entry, the detailed ledgers and records relating to the work of the several departments of the bank, and the control books and records. From this latter group the bank prepares its statement of condition. Special books are very often kept for particular accounts which are extremely active, and the totals are merely extracted from the special books and posted in the general ledger, thus reducing the size of the ledgers and simplifying the work. The individual customer's ledger, in which are kept the details of the deposits and checks drawn by each customer of the bank, is an example of such a special ledger, the total of the deposits, and the total of the checks paid for all customers, being the only entry made in the general ledger account for *Demand Deposits*. Machinery such as adding machines, posting machines, bookkeeping machines, canceling and indorsing machines, counting machines, and other labor-

saving devices are all being used by bookkeeping departments in order to facilitate their work.

It might also be desirable for a bank to keep a special ledger—sometimes designated the *expense ledger*—in order to record the operating expenses of the institution as well as the expenses connected with the building or buildings housing the bank. If a separate book is not kept, these entries are treated in the general ledger. Banks sometimes keep special ledgers to record the taxes which they must pay in the course of their operation. These taxes might consist of: (1) tax on capital stock; (2) real-estate tax; (3) Federal capital stock tax; (4) income tax; (5) excess-profits tax; (6) tax on undistributed net income; (7) stamp taxes; (8) circulation tax—if the bank happens to be a national bank; (9) personal-property tax.

The physical organization of the general bookkeeping department varies, of course, with the amount of work to be done by that department. This, in turn, is dependent upon the size and activity of the banking institution. The work of transcribing the records of the business of the bank is done by clerks whose activities are supervised by general clerks, the number of which is, of course, dependent upon the size of the department.

Auditing Department.—Large urban institutions will frequently have an auditing department in addition to the bookkeeping department. While outside bank-examining forces frequently examine the condition of the bank, and thereby check up on the records kept by the institution, yet it is regarded as good banking practice to have the accounts of the bank audited by professional auditing firms which receive a remuneration from the bank; or, if the bank is of sufficient size to justify the expense, to have a separate auditing department which will daily check up on the records of the bank and will tend to put the officials and the staff on their mettle.

The value of frequent audits of a banking institution is obvious. First, it tends to prevent fraud, and peculations on the part of the employees of the institution, because they realize that their chances of evading detection are considerably less if frequent audits are made of the affairs of the bank. Second, it reduces the possibility of large errors because of the frequent independent check being made. Third, it tends to develop an evolving system of accounting which changes with the improvements in machinery and methods. Fourth, it enables the directors and officers of the bank to be constantly informed of the real condition of the institution. Fifth, it develops the habits of more careful work on the part of all the employees of the institution.

Westerfield lists the divisions of an auditing department as follows: [1]

1. For handling the daily routine:
   a. The domestic accounts reconcilement subdivision
   b. The domestic accounts investigation subdivision
   c. The domestic accounts verification subdivision
   d. The foreign "our" accounts reconcilement and investigation subdivision
   e. The foreign "their" accounts reconcilement and investigation subdivision
   f. The foreign account verification subdivision
   g. The canceled coupon verification subdivision
   h. The expense bills checking subdivision
   i. The pass-book subdivision
   j. The statement and check-filing subdivision.
2. For handling the periodic examinations:
   a. Subdivisions for the examination of the departments of the bank
   b. Foreign branches subdivision.

Naturally, the organization and operation of an auditing department varies with the size of the institution and the inclination of those in charge of its operations.

Deposit Analysis.—A growing tendency exists among bankers to scrutinize carefully the accounts of their depositors in order to determine their profitableness to the bank. Up to the present time no standard methods for analyzing deposit accounts have been devised by bankers, and, as a matter of fact, it will probably be impossible to derive methods which would be applicable to all banks because of the multiplicity of problems surrounding the attempts to weigh the value of a depositor's account. It is apparent, however, that bankers should take some means of protecting themselves against carrying unprofitable accounts, because, after all is said and done, a bank, like any other business enterprise, should not be expected to render services for which it receives no remuneration. Many banks have, therefore, introduced methods to ascertain those accounts which are profitable for the bank to handle, and to catalogue such accounts as are deemed a burden on the institution.

A depositor in a bank receives many services from a modern institution. Not only has he the privilege of drawing checks in varying amounts against his account, thereby enabling him to pay in a manner more convenient than if cash were to be used, but in addition the well-run bank provides other services for the depositor. Among these might

[1] Westerfield, Ray B., "Banking Principles and Practice," in five volumes. Vol. 3, p. 772. The Ronald Press Company, New York, 1921.

be mentioned advice in regard to investments; safety-deposit vaults for safeguarding valuables; the cashing of checks other than their own checks for depositors; in many cases the payment of interest on deposit accounts; the collecting of dividends and interest on bonds; the collection of accounts for large customers, such as public utilities; the furnishing of check books; the making up of payrolls, and delivering them in armored cars; and similar services. The rendering of these services requires the bank to have available adequate facilities, and increases the amount of work necessary for the staff to perform. All of this costs the bank money, and the depositors should therefore be made to realize the value of the services rendered gratuitously by banking institutions.

To offset the expenses of these services, the bank lends out the deposits received to borrowers, at varying rates of interest, and the depositors' accounts must be of sufficient size to enable the bank to receive a profit therefrom after making allowance for an approximate charge of the services rendered the account. This does not necessarily mean that an account under $50, or any other stated sum, is not in itself a profitable account because the total amount is small. It might well be demonstrated that an account carrying an average balance of $30,000 is an unprofitable account, if it can be shown that the services rendered this account on a fair basis cost the bank over and above the interest received from lending out the balance at the market rate of interest.

To illustrate, assume that the X bank has a customer, Mr. Brown, who keeps an average balance of $30,000 in the bank. Mr. Brown is a manufacturer, and as such is compelled to draw checks of varying amounts against this account. He employs a force of 500 men and women, and is compelled to draw about 2,500 checks a month. This bank estimates the approximate cost of clearing a check at about 10 cents, and therefore the cost of clearing the 2,500 checks would be $250 per month. On the other hand, the income received by the bank, if one assumes that it had extended the $30,000 out at 6 per cent interest, would be only $150 per month. The bank, however, has to keep a legal reserve against the account, the amount being dependent upon the location of the bank, and in addition thereto it must have on hand a certain amount of till money or ready cash with which to meet sudden demands made upon it. Therefore, the bank could not lend out the full $30,000, but only some portion of it, which would probably vary from 75 to 85 per cent of that amount, or, in dollars, from $22,500 to $25,500.

Taking this same bank as an illustration, and assuming a salesgirl keeps a deposit account averaging $100 against which she draws only two checks per month on the average, the account costs the bank 20 cents, and at 6 per cent will return the bank from 45 to 48 cents a month. If the reserve was taken into consideration, the bank would be in a position to lend out $75 to $85. In either case, on the surface it would appear as if this account would be more profitable to the bank than that of the depositor with the average of $30,000.

These two illustrations are given in order to point out the pitfalls which are connected with the analyzing of deposit accounts. However, an analysis should not stop here. Still continuing with the two aforementioned accounts, the banker would have to take into consideration whether Mr. Brown was going to be a good customer in so far as borrowing from this institution is concerned, and whether this fact would not make his account far more profitable than the account of the salesgirl, even though on the surface an analysis of the two accounts would indicate the greater profitableness of the second. Then, again, Mr. Brown might be a person of influence in the community, and by reason of this fact would be in a position to direct new business to the bank, which would increase his value as a depositor. Thus, it is extremely difficult, if not impossible, to set any definite standard by which the profitableness of accounts can be measured, and the banker must view each account by itself, using only such approximations of expense as overhead and general cost of handling each item presented for collection.

Methods of Analysis.—Four general factors must be considered in the analysis of deposit accounts. Van Court [1] gives these factors as follows:

1. The amount of balance that can be loaned or invested. This information is secured from an *interest slip*.

The analysis period coincides with the interest-computation period. The illustrative interest slip is based on a quantity interest computation. The average daily outstanding balance or *float* can be calculated by using the Federal Reserve availability schedules. The average daily outstanding balance is subtracted from the average daily ledger balance, after which the reserves, both legal and till, are subtracted; the resulting figure is the net or loanable balance.

[1] Van Court, Lewis, "Analysis of Customers' Accounts," William Mann Co., Philadelphia, 1928.

2. The amount of income that such a balance when loaned produces at the average net rate on loans and investments.

The average net rate should be based on the return on all the loans and investments of the institution, and when applied to the loanable balance of the account the approximate income from such account can be determined.

3. The amount of all disbursements directly traceable to the account. These disbursements might consist of expense incurred in printing special check books, in the payment of interest to the depositor, etc.

4. The amount of general expense which should be equitably apportioned to each account.

It is an extremely perplexing problem to allocate, with any degree of accuracy, the share of the general overhead which a deposit account should bear. To simply proportion overhead amongst the several deposit accounts with relation to the activity of the account would not attain accurate results. It has been suggested that overhead costs might be determined for each account by proportioning the application of the following costs in overhead to each account.[2]

a. Activity cost, or the cost according to the number of units handled. The division of the total cost of handling all the checks cleared through the bank by the number of cleared checks gives the average cost of clearing one check. The multiplication of the number of units cleared for an account by the average cost per unit will secure the activity cost for the account.

b. Loan cost, which can be obtained by dividing the total cost involved in extending all the loans and investments of the bank by the total amount of deposits. The resultant sum can be applied to the individual's loanable account before the reserves are deducted.

c. Maintenance cost, which includes all the expenses of the bank such as rent, etc., which have not heretofore been considered. The amount applicable to one account is secured by dividing the total costs by the number of accounts.

[2] These were given in a lecture by J. H. Kennedy of the Analysis Department, Philadelphia National Bank, on the subject of "Deposit Account Analysis" before the Elementary Banking Class, Philadelphia Chapter, American Institute of Banking on Mar. 20, 1929.

The following form indicates how an account can be analyzed.

Analysis of Account of John Doe Corporation

Month of April, 1929

Gross Balance—daily average		$50,000.00
In Transit ("float"):		
$150,000 two-day points	$300,000.00	
100,000 three-day points	300,000.00	
50,000 four-day points	200,000.00	
20,000 five-day points	100,000.00	
(30-day period)	$900,000.00	30,000.00
Net Balance		$20,000.00
Less Reserve (15 per cent)		3,000.00
Loanable Balance		$17,000.00
Income on Loanable Balance, 30 days, 6 per cent		$85.00
Less Interest Paid—2 per cent on $20,000		33.33
Gross Profit on Account		$51.67
Less:		
Activity Cost:		
5,000 checks deposited at $0.03	$150.00	
100 checks collected at $0.25	25.00	
Loan Cost:		
25 cents per M ($20,000)	5.00	
Number Cost	2.50	
Special Check Book	5.00	187.50
Net Loss on Account		$135.83

Variations occur in practice in connection with the analysis of deposit accounts.

The following calculations are illustrative of a small but profitable account, and of a large but unprofitable account. These tables appeared in a publication of the Clearing House Section of the American Bankers Association.[1]

[1] Commercial Bank Management, Booklet 2, "Profit and Loss Operations," p. 12. Issued by the Clearing House Section, American Bankers Association, 110 East 42nd Street, New York.

Small Account, but Shows a Profit

Average Book Balance	$1,100.00	
Less—Average Float	300.00	
Average Net Balance	$800.00	
Less 10 per cent Reserve	110.00	
Loanable Balance	$690.00	
Interest Income $690 at 5.94 per cent		$3.42
Less Interest Paid		None
Interest Earnings		$3.42
Activity Cost:		
Four checks drawn at 0.03\frac{1}{2}$	$0.14	
Two checks deposited at 0.01\frac{1}{2}$	0.03	
	$0.17	
Administrative and Credit Cost:		
$1,100 at $0.83 per $1,000	0.91	
Total Cost		$1.08
Profit Each Month		$2.34

or $2.92 profit per $1,000 of net balance.

Large Account, but Shows a Loss

Average Daily Ledger Balance	$35,263.00	
Less—Average Daily Float	4,500.00	
Average Daily Net Balance	$30,763.00	
Less 10 per cent Reserve	3,076.00	
Loanable Balance	$27,687.00	
Interest Income $27,687 at 5 per cent		$115.36
Less Interest Paid		None
Interest Earnings		$115.36
Activity Cost:		
275 checks drawn at 0.03\frac{1}{4}$	$8.94	
14,053 checks deposited at 0.01\frac{1}{2}$	210.79	
	$219.73	
Administrative and Credit Cost:		
$30,763.00 at $.43 per $1,000	13.23	
Total Cost		$232.96
Loss Each Month		$117.60

or $3.485 loss per $1,000 of daily net balance.

Net Balance Necessary to Support Present Activity . . . $66,200.00

Without an analysis this account with an average daily balance of $30,763 might be considered desirable.

A Philadelphia bank finds it only necessary to analyze about 500 accounts out of depositors numbering approximately 6,500. However, monthly records are kept of all the accounts, but only 500 are analyzed intensively. The totals of the items, deposits, and deferred columns are carried forward to the top of the columns for the next month. The total of the ledger balance columns for the 3 months are added together to give the aggregate ledger balance for each customer. From this is deducted the amount of the float or deferred columns giving the collected balance a reserve of 10 per cent. (Legal reserve is deducted, leaving loanable balance.) The income on the account is then calculated on the loanable balance at the rate of 5½ per cent. From this is deducted interest at 2 per cent, this representing the amount of interest paid the depositor. The remaining sum is the profit on the account for the 3-month period. In the case of this bank, no service charge is imposed for an account showing a regular monthly profit. However, in the case where there is apt to be frequent loss incurred by the bank in handling an account a minimum service charge of $1 is levied against the depositor. It will be noted that this method of analyzation of accounts makes no charge for overhead expenses, other than the fact that some allowance is represented in the amount set aside for handling the items collected. This method also makes no allowance for the till money reserve which of necessity must be kept by the bank against its deposits and which is an addition to the 10 per cent legal reserve.

Another Philadelphia bank analyzes all accounts quarterly. The records kept are approximately the same as in the description above. This bank, however, deducts a reserve of 15 per cent in order to arrive at the loanable balance and it charges eight times as much for the handling of a collection item as for checks simply drawn on the bank itself.

The Committee on Bank Costs of the New York State Bankers Association recently made a study of the unprofitable account. The following quotations and tables are from their report appearing in a recent issue of the *Commercial and Financial Chronicle:* [1]

The Committee on Bank Costs prepared and sent to every bank in the state a questionnaire containing a list of questions on unprofitable checking accounts. These questionnaires were exceedingly brief and simple, consisting of only nine questions on one side of a single sheet of paper and all the essential queries could be answered by a simple *yes* or *no*, or by figures which are readily

[1] *Commercial and Financial Chronicle*, p. 1379, Aug. 31, 1929.

available in all banks, such as *number of checking accounts, number carrying balances of less than $100, amount of deposits*, and so on.

About 68 per cent of the banks to which this questionnaire was sent replied, with the following results:

TABLE VI.—STATEMENT IN RELATIVE AMOUNTS IN CHECKING ACCOUNTS

(In Dollars and Percentages)

Group numbers	1 Checking accounts, number	2 Accounts of $100 or less, number	3 Relation to all deposits, per cent	4 Aggregate deposits of $100 or less, dollars
I	124,019	62,689	50	$1,995,938
II	38,238	21,107	55	731,312
III	63,319	36,118	57	1,033,876
IV	207,764	96,610	46	3,111,617
V	86,259	32,877	38	1,236,483
VI	79,984	23,581	30	1,008,630
VII	112,456	61,283	54	1,737,221
VIII	110,811	8,089	7	385,552
Total	822,830	342,354	......	$11,240,629
Average	102,854	42,794	42	1,405,078

Group numbers	5 Relation to all deposits in group, per cent	6 Average of each account under $100, dollars	7 Total deposits subject to check, dollars	8 Average of each account in total, dollars
I	3	$32	$72,987,848	$588
II	6	35	12,513,491	327
III	3	28	33,771,664	517
IV	2	32	158,500,341	762
V	2	28	84,915,301	757
VI	2	28	54,956,843	637
VII	1	42	71,129,374	888
VIII	0.03	47	105,663,923	9,530
Total	......	......	$594,438,785	
Average	2.38	$34	74,304,848	$1,750

From the foregoing table it can be seen that in half of the groups of the state, the checking accounts of $100 or less constitute at least one-half of all accounts. The average is 42 per cent, even counting the exceptional figures of Group VIII (metropolitan district). Without this group the number of such accounts constitutes an average of a little more than 49 per cent, or nearly one-half.

TABLE VII.—RECAPITULATION OF REPLIES RECEIVED TO QUESTIONS 5 TO 9

Group numbers	1	2	3	4
	Making charge	Not making charge	Considering charge	Asking for facts
I	37	57	23	12
II	7	30	12	9
III	12	23	15	15
IV	30	68	16	7
V	6	63	26	9
VI	24	39	6	2
VII	34	39	9	2
VIII	23	7	0	0
Total	173	326	107	56
Average	22	41	16	7

Group numbers	5	6	7	8	9
	Ready for charge if others do	Not analyzing large accounts	Analyzing large accounts	Circularizing depositors	Not in favor of charge
I	16	58	31	32	8
II	6	19	18	4	11
III	5	14	21	12	3
IV	6	58	40	19	22
V	15	57	12	9	14
VI	11	45	18	13	11
VII	4	48	25	16	9
VIII	0	10	20	6	0
Total	63	309	185	111	78
Average	8	39	23	14	10

Sifting all the evidence before it, the committee comes to the definite conclusion that a cost-carrying charge is the only fair and just method of handling

small checking accounts which are now sources of loss. That charge may be on the basis of a flat charge of a dollar a month for all accounts that do not maintain a balance of $100. Customers can readily be taught to see that checks and stationery cost money, that expenses of handling small accounts are far greater than any returns the bank can receive, and that checks, as records and receipts, have a distinct value.

Personally, the authors do not agree with the general conclusions of the committee, which simply penalize an account because of its size and regardless of its activity or the cost to the bank in handling it. Pitfalls await the banking business if reckless, ill-considered, and general service charges are levied. After all is said and done, the banking business should study the experience of public utility operation in this country, and profit thereby. Public utility operators are agreed today on the wisdom of their new policy of pleasing the public and acquiring their sympathetic cooperation rather than their ill will. Service charges are apt to produce an ill will in a community which can result in tremendous damage to a banking institution.

The whole subject of account analysis must be regarded as being in a state of development rather than in final form, and, as previously stated, rules cannot be made which are applicable to all banking institutions, and to all depositors of such banks. Then, bankers must keep in mind the fact that the small depositor of today may be the large depositor of tomorrow; that satisfied depositors, whether small or large, are the best form of advertisement for a banking institution; that the more depositors a bank gets the more widespread its influence becomes. The following quotation from a recent article appearing in an American periodical is of interest:

Before the World War it was customary in certain banking systems, notably in the Levant, to charge depositors for the use of banks—a principle which never failed to excite our derision. Today we find that our banks have adopted this Levantine technique as an article of their financial creed.

I do not know the unnamed genius who discovered that it cost the banks money to handle checking accounts. Perhaps it was an efficiency expert, perhaps a janitor. At any rate, the fatal discovery was made and promptly applied. Today there is scarcely one important bank—at least in the Eastern United States—which does not charge its small depositors for the use of its facilities. . . .

This is sheer stupidity. There is no denial of the fact that it costs a bank money to handle checks. But it also costs a bank money to install bronze, marble, and plate-glass fixtures. The latter may run the bank's overhead into hundreds of thousands of dollars, but are considered good advertising. Steady small depositors are not, apparently, in the same category.

They are, on the contrary, treated as a nuisance, and I have yet to hear any banker protest at the loss of good will which this practice involves, let alone the loss of business. I say loss of business advisedly. The average human being follows the line of least resistance. If he has business to transact, a note to discount, a mortgage to negotiate, or money to invest, he will handle it through the agency which attends to his other financial affairs. Again, this country is full of economic surprises. The man who runs a fruit stand today may be president of a fruit company tomorrow. The thirty-dollar-a-week clerk of this year may be the sales manager of next. The underpaid chemical professor may discover a formula which will make him rich overnight; and so on. There is a gambling chance in every depositor, which, if overlooked, may cost a bank considerable patronage in the future.[1]

References

VAN COURT, LEWIS: "Analysis of Customer's Accounts."
WALL, ALEXANDER: "The Banker's Credit Manual."

[1] CARTER, JOHN, "A Moral Crisis in Banking," *American Mercury*, Vol. 17, No. 68, p. 413, August, 1929.

CHAPTER XVIII

THE TITLE INSURANCE DEPARTMENT

Many trust companies, in connection with their other activities, engage in the business of issuing policies insuring titles to real estate. In some of the older companies making a specialty of this activity, the name *title insurance company* may and frequently does appear in the official title of the bank. It is not necessary, however, that the name of the bank should indicate this activity. The bank may engage in it if authorized to do so by its charter and by the incorporation laws of the state in which it is incorporated.

The business of title insurance is of comparatively recent development. For example, in Pennsylvania the first charter granted to a company authorizing it to insure titles on real estate was that granted to the Real Estate Title and Trust Company of Philadelphia in 1876. Since that date their growth has been rapid in the larger and more settled communities where real-estate transfers have been sufficiently numerous to make the business of insuring titles remunerative.

Prior to the formation of title insurance companies, purchasers of land, or mortgagees lending money on the security of land, protected themselves against defects in the title of the property purchased, or upon which they were lending money, by employing lawyers or conveyancers to search the title and to prepare what were known as *abstracts of title*, which traced title back for a considerable period, and who examined into any encumbrances, liens, or other defects to the title which might exist. These abstracts of title, if properly prepared, were of great value, and much reliance was properly placed upon them, but the attorneys and conveyancers issuing these abstracts did not guarantee their accuracy and no recourse could be had against them except for gross negligence in the event of certain defects coming to light which were not disclosed by the abstract. This practice of title searching by lawyers or conveyancers still exists in country districts and localities where title insurance companies do not operate.

Briefly, the title insurance companies do the work which these conveyancers formerly did. They search against the property for defects

in title or encumbrances; but they differ from the old conveyancers in that they guarantee the accuracy of their search by issuing title policies based upon their findings, upon which they are liable in the event of any loss accruing to the holder of the policy resulting from defects of title or encumbrances which were not disclosed by the title company's search.

For the purpose of making such title and encumbrance searches, the larger title insurance companies of today have what is known as a *plant,* which consists of a practical duplication of the records of conveyances, mortgages, and other liens which are officially recorded by the proper county authorities. The searches, in many cases, can be made with great rapidity and with but little work involved, if, as frequently happens, the new application for a title policy covers a property upon which the company has recently made a search at the time of its former transfer. In companies doing a large business it invariably occurs that a substantial proportion of the applications for title insurance cover properties upon which that company has issued other policies in the recent past.

Some of the smaller companies act merely as agents for the larger title insurance companies, dividing the fee and transferring to the larger company a substantial portion of the burden of searching title. In such cases the smaller company may actually issue the title policy of the larger company, acting frankly as an agent, or it may issue its own policy and then re-insure the title with a larger company, in which case its agency relationship is concealed.

Application.—The process of issuing title insurance policies is approximately as follows: A person proposing to purchase property, or an individual, or financial company proposing to lend money on the security of property, will apply for title insurance on a form prepared by the title company. Upon receipt of this form the title company will give it a number, and further references to the application or to matters arising thereunder should refer to that number. However, the title company keeps elaborate indices of its operations and it is customary to index one application under its number, under the name of the applicant, and under the location of the property, so that the company can answer inquiries concerning that transaction if any of those three facts are known.

The application states: (*a*) The amount of title insurance desired. As will later be indicated, the charges made for title insurance are frequently on a percentage basis of the amount of the policy, and many companies therefore have a minimum policy which they will issue.

(*b*) Location of the property. (*c*) The name of the present owner or owners and the name of the purchaser or mortgagee or other parties in interest. (*d*) The known mortgages and other encumbrances upon the property. (*e*) The nature of the interest to be insured.

The application is somewhat formal in its nature. Its only real significance other than, of course, the obtaining of a record of the transaction for the company, is that if a knowingly false statement is made in the application it constitutes a defense by the title company on a claim against it for title insurance, if the claim is made by the one who made the false statement or on whose behalf it was made with his knowledge.

Settlement Certificate.—Upon receipt of the application and upon making the necessary index references according to the method of keeping such records by the company, a search is made of the title and encumbrances, and the result of that search is embodied in what is known as a *settlement certificate* a copy of which goes to the applicant, to mortgagees if they are interested, and a copy is of course retained by the company. This settlement certificate indicates the status of the title, states the encumbrances and other defects which were discovered by the search, and contains whatever objections against the title may appear, all of which will be excepted from the title policy unless removed at or before the settlement.

By settlement is meant the actual passage of the instruments of conveyance on the one part and the consideration on the other by the parties to the transaction. The following is a copy of a typical settlement certificate:

SETTLEMENT CERTIFICATE

THE DORCHESTER TITLE AND TRUST COMPANY

No. 176542 Jan. 6, 1930

. . . .

Conveyance of premises north side of Wilton Street, 218 feet west of Preston Street, in the forty-eighth ward of the city of Philadelphia, 22 feet by 125 feet, about to be made by Edward Hoyt, trustee under the will of Henry Rogers to Albert W. Clark. Premises No. 4213 Wilton Street.

The premises are subject to the following encumbrances and claims which will be excepted in the policy unless removed.

. . . .

MORTGAGES

1. Harry Rogers to Northern Trust Company for $8,500, Dated Mar. 28, 1921. Recorded W.S.V. 63/426.
2. Henry Rogers to Henderson Building and Loan Association for $3,000, dated Apr. 23, 1925. Recorded W.S.V. 86/245. (Balance to be paid off.)

REGISTERED TAXES

3. Taxes for the year 1928, lien filed Dec. 28, 1929. C.P. 3 Dec. T. 1929. No. 4356. $299.25.
   Taxes for the year 1929, $342 and penalty.

TAXES FOR THE CURRENT YEAR

4. Not paid, assessment $12,000.

WATER RENT

5. $48 paid for current year.

MECHANICS AND MUNICIPAL CLAIMS

6. City to use v. Rogers C.P. 2 June T 1927. No. 5640. Footway Repairs. Filed June 18, 1927. $36.54.

JUDGMENTS

7. William Gordon vs. Henry Rogers C.P. 3 June T 1928. No. 436 $350—Entered Aug. 13, 1928.

OBJECTIONS

8. Parties to be identified.
9. Declaration as to purchase money mortgage.
10. Deed from Edward Hoyt, trustee, etc., to be produced and recorded.
11. Proof that Henry Rogers did not marry nor have children born after the date of his will (Dec. 3, 1914) and that he left no wife surviving.
12. Subject to terms and conditions of any unrecorded lease.
13. Company inspector reports steps at side of house appear to encroach on adjoining premises to the east.
14. Is this transaction within the bankruptcy or insolvency acts?
15. Where deed, mortgage, or other instrument is made by or to a bank or trust company, certificate of notary must state that he, the notary, is not a stockholder, director or officer of said bank or trust company. Proof that this does not come within the provisions of the Bankruptcy Act of July 1, 1898, or of the Insolvency Act of June 4, 1901.
16. This company will not guarantee accuracy of description unless furnished with an official survey.
17. In order to protect the insured from loss by reason of defects arising between this date and the final settlement, it is recommended that the consideration money be deposited with the company, and, if the amount be sufficient, the company will then pay off the encumbrances.
18. And when the transaction is settled and the papers recorded (which recording must be done by the company) a policy of insurance for $14,500 will be issued in conformity with the application No. 176542.

Title Officer

The title company is liable for the accuracy and completeness of the settlement certificate, and signing it at the bottom by the proper officer of the title company constitutes a binding contract between the applicant for title insurance and the title company, even prior to the issuance of the title policy.

Upon receipt of his copy of the settlement certificate, the applicant

for title insurance proceeds to clear the certificate of all objections which are not to be taken care of at settlement, and which are not to remain against the property and to be excepted from the title policy. When the objections have been met or eliminated in a way satisfactory to the title company, this fact is indicated on the settlement certificate by the title officer crossing out the objection and initialing it. This indicates that the objection has been satisfactorily removed. For example, a judgment may appear against an individual of the same name as the owner of the property. Such judgment will appear on the settlement certificate as an objection to the title. It may be, however, that although the judgment was against an individual of the same name it was not against the owner of the property. The title officer being satisfied of that fact—proof can readily be had by correspondence with attorneys who obtained the judgment—the title officer will remove that objection.

The settlement certificate being dated a week or more in advance of the settlement date, it is necessary that the title company search from the date of the certificate to the date of settlement. This search is made on the day of or the day prior to the settlement, depending on the hour of the day when settlement is to take place, and is known as *the bring down.*

Settlement.—The settlement itself may take place at the title insurance company's offices, or anywhere else. Title insurance companies prefer to have settlements made at their offices, and for that purpose provide settlement rooms and a number of settlement clerks to preside at the settlement, make the necessary calculations, and represent the title insurance company.

Let us assume that settlement is made at the office of the Dorchester Title and Trust Company on Jan. 13, 1930. The deed from Edward Hoyt, trustee, under the will of Henry Rogers, deceased, to Albert W. Clark, is produced, duly executed and approved as to form by the title officer. The said Henry Rogers obtained title to the property by deed from Howard Stephens, July 12, 1906, and died Oct. 10, 1928, leaving a will by which he devised and bequeathed all his estate to his executor, Edward Hoyt, as trustee, with directions, to convert the real estate and invest proceeds and pay income to his, Henry Rogers', daughter for life, with remainder over to her children—in the event of failure of issue, then to the daughter's appointee. The wife of Henry Rogers died before him and he did not marry again. The interest on the first mortgage at the rate of 5.4 per cent has been paid to Sept. 28, 1929, as shown by the interest receipts.

Before the settlement clerk can make a settlement which will prove satisfactory to all parties, it is essential that he possess certain information relating to the existing mortgages and liens. This information is set forth in detail herewith:

There was a second building and loan association mortgage on the property which is to be paid off at the time of settlement. It has already been partially paid in the payments on the shares of stock that the mortgagor must take out in the association when the mortgage is placed. These payments have run from April, 1925, to January, 1930, and amount to $870. The building and loan association allows 5 per cent interest to the stockholders on withdrawals made after the fourth year and the amount of this interest to the credit of the stockholder is $102.71. This information is supplied by the building and loan association.

The taxes for 1928 were not paid by the grantor. The city has, therefore, filed a tax lien which includes the amount of the tax and interest, penalties, and costs. The delinquent tax office supplies the figures for this.

The 1929 taxes are also unpaid, but no lien has been filed. The 1929 taxes, however, are delinquent and a penalty of 5 per cent is imposed with interest at 6 per cent per annum. Figures showing the amount due will be supplied by the delinquent tax office.

The 1930 taxes are also unpaid.

The city repaired the footway before the house and has assessed the cost on the property owner for an amount of $46.54.

The costs of the legal proceeding to enforce the claim amount to $5.37 and interest amounts to $5.25.

The settlement certificate has shown a judgment against the owner's property which is a lien on the property. This judgment amounts to $350, interest on which to the date of settlement amounts to $29.75, and the costs of judgment are $2.50.

The cash consideration is $6,000, of which $500 has been paid on account. The property is purchased subject to a first mortgage of $8,500. The premises are rented to Walter T. Bell on a yearly lease dated Feb. 1, 1929, for $1,500, payable monthly in advance. Rent has been paid to Feb. 1, 1930.

The objections on the settlement certificate as to title have to be removed at the time of settlement, or settlement will not be made by the settlement clerk of the title company. The objections on the settlement certificate are *parties to be identified.* This identification should be made by some one known to the settlement clerk or official

of the company. A declaration must be made by the grantor that no purchase-money mortgage has been given. The proof that the decedent, Henry Rogers, did not marry nor have children born after the date of his will and that he left no wife surviving is usually furnished by an affidavit made by the grantor. In this instance, the affidavit would be made by Edward Hoyt. The company is usually satisfied with such an affidavit and will mark the particular objection removed on the settlement certificate. The company will note an exception as to the encroaching steps unless the steps are changed or proof submitted by means of a survey of the fact that they do not encroach on adjoining premises. The title company will note an exception on the policy: *accuracy of description and dimensions,* unless an official survey made by the district surveyor is produced at the time of settlement and the clerk is able to verify the correctness of description. The title company never assumes any responsibility with respect to possession of the premises. Usually, possession is given by delivery of the key at time of settlement or by assignment of lease.

The information contained in the settlement certificate, together with the additional data as shown above enables the title company's clerk to proceed with the settlement and distribution of the funds. This may be accomplished by using an accounting form similar to the following.

THE DORCHESTER TITLE AND TRUST COMPANY

MEMORANDUM OF SETTLEMENT

No. 176542. 1/13/30

Settlement made by Albert W. Clark with Edward Hoyt, Trustee, for purchase of Premises No. 4213 Wilton Street

Debit

Consideration, Subject to Mortgage of $8,500	$6,000.00	
Fire Insurance: Policy No. 684421, $280 less 10 per cent	252.00	
Water Rent, Current Year, $48 less $1.73	46.27	
Acknowledgment of Deed	0.50	$6,298.77

Credit

Paid on Account	$500.00	
Taxes of Current Year, $338.58—13 Days	12.35	
Interest on Mortgage, W.S.V. 63/426 from 9/28/29 at 5.4 per cent	135.00	
House Rent, 18 Days, $4.03 per Diem	72.54	719.89
Balance Due Grantor		$5,578.88

Settlement with Grantor

Fund Due Grantor in Settlement			$5,578.88
Mortgage, W.S.V. 86/245	$3,000.00		
Value of Book	972.71	$2,027.29	
Satisfaction Fee		2.00	
Taxes and Water Rents:			
1919 Lien	$299.25		
Interest from 12/28/29	0.80		
Costs	4.62	304.67	
1920 Lien	$342.00		
Interest from 1/1/30	0.74		
Penalty	17.10	359.84	
City to Use Claim C.P. 2 J 1927 No. 5640	$36.54		
Interest from 6/18/27	5.23		
Costs	5.37	47.14	
Judgment C.P. 3 J 1919 No. 436	$350.00		
Interest from 8/13/29	29.75		
Costs	2.50	382.25	
George Hall, Commission		350.00	3,473.19
Balance of Settlement Payable to Grantor			$2,105.69

Settlement with Grantee

Fund Due Grantor	$5,578.88	
Title Insurance Charges: Examination and Premium	102.50	
Taxes and Water Rents: Current Year	338.58	
George Hall, Conveyancing	15.00	
Recording	3.75	$6,038.71
Fund Necessary to Complete Settlement		$6,038.71

The above settlement examined and approved, in consideration of which the Dorchester Title and Trust Company is directed and authorized to make distribution and payments in accordance herewith.

Approved:

Approved: (Signed) Albert W. Clark. (Signed) Edward Hoyt, Trustee

Summary.—In summary, the foregoing settlement account shows that the grantee agreed to purchase this property for the sum of $14,500.00. Of this amount a first mortgage of $8,500 remains upon the property. The grantee, to finally complete the settlement, has actually to pay in cash $6,038.71. The additional sum over and above the $6,000 cash mentioned in the agreement of sale is to cover the items of fire insurance, water rent for the balance of the year, taxes for 1921,

conveyancing and company charges, and recording charges, less the items of rent, interest on first mortgage and current taxes for which the grantee receives credit.

The grantor receives $2,105.69 in cash. The balance of the consideration has gone to pay off the amount due on the second mortgage, to pay off the judgment, delinquent taxes, city claims mentioned above in the settlement, and the commission to the real-estate broker who negotiated the sale, etc.

It follows, therefore, that if the above account is correct, the sum paid in by the grantee must be equal to the sums paid out. An analysis of the items discloses the following. The grantee pays $6,038.71. This amount is distributed as follows:

Grantor	$2,105.69
George Hall, Commission	350.00
Taxes (1928)	304.67
Taxes (1929)	359.84
Taxes (1930)	338.58
B. & L. Mortgage	2,027.29
Satisfying B. & L.	2.00
City Claim	47.14
Judgment	382.25
George Hall (conveyancing)	15.00
Title Insurance	102.50
Recording Charges	3.75
	$6,038.71

One or two other items may need some explanation. Fire insurance ($252) was paid for originally by the grantor, who has now sold it to the grantee, the amount being included in the sum of $2,105.69, which the former receives. This is true also of the item of water rent, amounting to $46.27, the grantor having paid this for the year in advance. The acknowledgment fee ($0.50) was also paid by the grantor, who was reimbursed by the grantee, by adding the 50 cents to the price of the property. The tax discount for 1930 of $12.35 and the house rent of $72.54 are very obviously not amounts to be paid.

In the case of the interest on first mortgage ($135) for which the grantee receives credit, this sum is the share payable by the grantor. The grantee holds this sum until the interest due date (namely, Mar. 28) then adding his own share, pays the total amount due.

The foregoing settlement is intended to illustrate the principles involved in real-estate settlements. Certain title companies may use forms differing in set-up from the form given above. Certain changes

in the figures are necessitated from time to time. Tax rates may vary from year to year; companies may change their service charges. Some companies insist upon title insurance for the full consideration price, others fix minimum policies and minimum charges. The satisfaction fee for building and loan mortgages may be increased, etc. Some title companies today do not search for unpaid taxes, requiring instead the production of tax receipts at the settlement.

All papers to be recorded are turned over to the title company, which is responsible for their being properly and promptly recorded. When the papers to be recorded have been copied, the title insurance company obtains them from the Recorder of Deeds' office, and sends them back to the owner. And, finally, when all matters have been properly concluded, it issues its policy in the amount applied for, insuring the title, subject to such objections as appear in the policy, against any defects existing prior to the settlement. But note: it does not insure against any defects arising thereafter, so that when the property is resold or remortgaged, the new purchaser or mortgagee will require a new policy, so that the intervening period will be covered. A simple assignment of the old policy would leave that period of time unsecured.

Policy.—The policy insures against: (*a*) Identity of the parties. For example, if Mr. Jones purchases a property from a gentleman who purports to be Mr. Smith, the owner, but who in reality is not Mr. Smith, the owner, a title policy issued to Mr. Jones will cover that risk, and if the real owner, Mr. Smith, appears and recovers the property, as he would have the legal right to do, Mr. Jones can collect its value from the title insurance company. (*b*) The validity and genuineness of instruments of title. Holders of title policies under this provision are insured against forged or fraudulently executed instruments. (*c*) Other deeds given by the grantor prior to this transaction, but which may be recorded within a legal time limit. (*d*) Legal ability of grantors or mortgagors to execute deeds or mortgages. For example, the holder of title policy would be insured against loss from taking a deed or mortgage from a minor or from a fiduciary without authority to execute the instrument. (*e*) The construction of deeds, wills, etc. For example, the purchaser from an individual who obtained title by will to the property which he was selling would be protected under his title policy against any later adverse court decision which affected the title of the beneficiary, under the will, as, for instance, a declaration by the court that the will was invalid. (*f*) Hidden easements and clouds on the title. (*g*) Title companies do not insure accuracy of description unless an official survey was made before settlement.

The liability of the company under its title policy includes liability to pay counsel fee and other costs in the defense of actions affecting the title. When an adverse claim, which would be covered under the policy, arises, it is customary for the title company to file a defense and pay the necessary costs, and if a judgment is obtained against the holder of the policy, to pay that judgment.

Upon payment of such damages the title company is subrogated to the right of the insured in claims against the grantor under the warranties in the preceding transfer.

For the services outlined above, title insurance companies in Philadelphia charge $25 for the title examination, $5 for the services of the settlement clerk, and settlement room, and in addition a premium for the policy which is ordinarily one-half of 1 per cent for policies insuring owners, and one-fourth of 1 per cent for policies insuring mortgagees. For the payment of one-half of 1 per cent the company will issue policies insuring mortgages, and to the owner an owner's certificate making the policy transferable to the owner without further cost upon satisfaction of the mortgage. This would terminate the liability of the company under an ordinary mortgagee's policy. Where the owner's certificate has been issued, the policy continues as an owner's policy, after the mortgage has been satisfied. Such certificates are, however, only issued when the full consideration for an owner's policy has been paid.

Real Estate Department.—In connection with the Title Insurance Department or with trust work in which the management of real estate in involved, banks frequently maintain real-estate departments. In handling real estate, the bank may act as agent for the sale of real estate, the renting of real estate and collection of rent, making appropriate charges in accordance with the recognized reimbursement for such services in the community in which the bank operates. It may appraise real estate for the loan department in reference to applications for loans on real estate.

Banks, in some states, may insure mortgagees and others against mechanic's liens, and, in respect to the sale of construction mortgages, insure completion of the building. In the handling of real estate in trust relations, or real estate purchased to protect loans, this department will be responsible for looking after alterations, repairs, and upkeep.

Some banks carry on a mortgage business, taking mortgages on improved property and reselling them in whole or in fractional parts to investors, with or without the bank's guaranty. In the sale of frac-

tional parts of the mortgage, the bank issues, to purchasers, participation certificates bearing interest at a lower rate than the mortgage. The difference in rate plus a commission for placing the mortgage, such commission is charged, represents the bank's income. Purchasers of these certificates have the services of the bank in the selection of sound mortgages, the collection of interest, and attention to the details of the maintenance of fire insurance, payment of taxes, etc., and in some cases the guaranty of the bank for the due payment of interest and principal.

CHAPTER XIX

THE TRUST DEPARTMENT. INDIVIDUAL TRUSTS

The trust business, consisting as it does of carrying out certain fiduciary obligations, is in no sense a banking activity, and has been adopted and is performed today by our banks largely as a result of accidental growth. There is no logical or necessary relationship between trust activities and banking. The trust function could be as well performed by corporations organized solely for that purpose and which perform no banking function whatever, and trust activities could be, and today are, performed by private individuals.

The relationships and activities involved are legal, rather than financial. Trust functions are performed by banks today only in the sense that the Trust Department occupies the same premises as the Banking Department; that it operates under the same charter and has the same officers; otherwise it is a totally separate business activity. The laws of most states require that separate books representing its activities be kept by the Trust Department; that the funds in the possession of the Trust Department shall be deposited with some bank other than the one of which it is a part.

The Trust Department's activities are ordinarily under the direction of one or more vice-presidents who may or may not supervise in any way the banking activities of their institution. The qualifications for the vice-president or trust officer or official in charge of trust activities differ radically from the qualifications necessary for the successful supervision of the banking activities. Thus, for example, the trust officer should have legal training, as a large part of his activities require direct contact with the courts.

Trust activities are, in the banking field, carried on by: trust companies operating under a state charter; state banks to which trust powers may have been granted by statute, and national banks which have exercised the authority to engage in trust activities granted by the Federal Reserve Act and its amendments.

National Banks.—Prior to the passage of the Federal Reserve Act, national banks were not authorized to engage in trust or fiduciary activi-

ties. But by Sec. 11, paragraph *k* of the Federal Reserve Act, the Federal Reserve Board is authorized and empowered:

To grant by special permit to national banks applying therefor, when not in contravention of state or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardians of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which state banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the state in which the national bank is located.

Whenever the laws of such state authorize or permit the exercise of any or all of the foregoing powers by state banks, trust companies, or other corporations which compete with national banks, the granting to and the exercise of such powers by national banks shall not be deemed to be in contravention of state or local law within the meaning of this Act.

National banks exercising any or all of the powers enumerated in this subsection shall segregate all assets held in any fiduciary capacity from the general assets of the bank and shall keep a separate set of books and records showing in proper detail all transactions engaged in under authority of this subsection. Such books and records shall be open to inspection by the state authorities to the same extent as the books and records of corporations organized under state law which exercise fiduciary powers, but nothing in this Act shall be construed as authorizing the state authorities to examine the books, records, and assets of the national bank which are not held in trust under authority of this subsection.

No national bank shall receive in its trust department deposits of current funds subject to check or the deposit of checks, drafts, bills of exchange or other items for collection or exchange purposes. Funds deposited or held in trust by the bank awaiting investment shall be carried in a separate account and shall not be used by the bank in the conduct of its business unless it shall first set aside in the trust department United States bonds or other securities approved by the Federal Reserve Board.

In the event of the failure of such bank, the owners of the funds held in trust for investment shall have a lien on the bonds or other securities so set apart in addition to their claim against the estate of the bank.

Whenever the laws of a state require corporations acting in a fiduciary capacity, to deposit securities with the state authorities for the protection of private or court trusts, national banks so acting shall be required to make similar deposits and securities so deposited shall be held for the protection of private or court trusts, as provided by the state law.

National banks in such cases shall not be required to execute the bond usually required of individuals if state corporations under similar circumstances are exempt from this requirement.

National banks shall have power to execute such bond when so required by the laws of the state.

In any case in which the laws of a state require that a corporation acting as trustee, executor, administrator, or in any capacity specified in this section, shall take an oath or make an affidavit, the president, vice-president, cashier, or trust officer of such national bank may take the necessary oath or execute the necessary affidavit.

It shall be unlawful for any national banking association to lend any officer, director, or employee any funds held in trust under the powers conferred by this section. Any officer, director, or employee making such loan, or to whom such loan is made, may be fined not more than $5,000 or imprisoned not more than 5 years, or may be both fined and imprisoned, in the discretion of the court.

In passing upon applications for permission to exercise the powers enumerated in this subsection, the Federal Reserve Board may take into consideration the amount of capital and surplus of the applying bank, whether or not such capital and surplus is sufficient under the circumstances of the case, the needs of the community to be served, and any other facts and circumstances that seem to it proper, and may grant or refuse the application accordingly: *Provided*, That no permit shall be issued to any national banking association having a capital and surplus less than the capital and surplus required by state law of state banks, trust companies, and corporations exercising such powers.

These trust powers are executed under the authority and supervision of the officials and laws of the state in which the national bank is located. In other words, local statutes governing the nature of such trust activities must be complied with, and, in regard to its trust business, the national banks are subject to state supervision and examination.

State Banks.—All trust companies organized under the authority of any state law have full trust powers, and the so-called state banks not organized specifically as trust companies generally have the authority to engage in a trust business under state statutes.

Trust Functions.—The more important trust functions may be divided into two categories: individual trust activities and corporate trust activities. The individual trust functions are: (*a*) acting as executor or administrator in the settlement of estates; (*b*) acting as trustee for the carrying out of private trusts; (*c*) acting as guardians of the persons and estates of minors; (*d*) acting as agents or attorneys for the carrying out of innumerable activities for and in place of private individuals, for example: the management of estates, the management of properties, including the renting and collection of rents and physical care of the property, the custody of securities and the collection of income therefrom, the satisfaction of mortgages, etc; (*e*) certain special services, for example: assistance and advice in drawing up wills, making out income-tax returns, etc.; (*f*) acting as receiver. The cor-

porate trust activities are: (*a*) corporate trustee; (*b*) fiscal agent; (*c*) registrar; (*d*) transfer agent; (*e*) syndicate manager; (*f*) depositary; (*g*) assignee; (*h*) receiver.

In addition to these trust functions generally executed by trust companies there may be combined certain activities not directly related to the trust business and now to a large extent carried on by separate independent companies, such as the business of insuring titles to real estate, making examinations into titles and aiding in various ways in the transfer of real property.

Individual Trusts. *a. Executor or Administrator.*—A large proportion of the business of the individual trust department consists of the winding up and settlement of estates of deceased, the trust company acting in the capacity of executor or administrator. The duties of these two offices are practically analogous, the difference in name resulting from the fact that in the case of an executor the appointment is made by the decedent in his will, whereas in the case of an administrator the appointment is made by the court having authority over estates of decedents.

Appointment.—The appointment by the decedent as executor results from business contacts existing between the trust company, its officers and directors, and clients and customers of the institution. It has become customary for trust companies to volunteer their services free of charge in aiding depositors, stockholders, and other customers of the bank in the preparation of their wills. Although the trust officer will give such advice irrespective of the person appointed as executor, nevertheless it is generally expected that when such advice is given without charge the trust company will be named either as sole executor or co-executor. If the trust company is so named as executor, it also acts free of charge as custodian of the will.

Appointments as executor also frequently come from attorneys who are employed by their clients to draw up wills and who frequently advise such clients to name as executor or co-executor some responsible trust company. It frequently happens that the lawyer himself will be named as executor, and in many cases it is at the lawyer's request that a trust company is joined with him as co-executor. The lawyer benefits in that most of the detail work, including the custody of securities, the keeping of accounts, the preparation of such accounts for court audit, etc., are performed by the trust company's employees, the lawyer being consulted only on matters of policy and any legal questions which may arise, and receiving half of the commission payable to the executors.

It is also a common practice of trust companies to make it generally

known that for attorneys who recommend to their clients the naming of that trust company as executor the trust company will retain the attorney as counsel in settlement of the estate, instead of utilizing its own trust counsel. This is obviously just, as attorneys who have been handling the business affairs of individuals prior to their death are generally better able to appraise the conditions and properly advise the executor in matters concerning the business affairs of their former clients and they are entitled to the appointment, as the naming of the trust company as executor probably resulted from their recommendation.

The actual process of qualifying as executor varies in minor ways according to the laws and procedures of the different states. It is generally true that an individual or corporation named in a will as executor is not required to file any bond or put up any security for the proper performance of the duties of the office.

The Probate of the Will.—The first step is the probate of the will. The term *probate* means simply proving the will, which consists of taking it to the office of the recorder or register of wills or similar official, whatever name may be given to him by practice and procedure of that state, together with witnesses who have signed the will attesting to the signature of the decedent, or, in case there are no subscribing witnesses, two individuals who can recognize the handwriting of the decedent. This latter procedure applies only in states where wills without subscribing witnesses are valid.

The register, if satisfied that the will is valid and that all of the necessary steps have been properly taken, will issue formal letters testamentary to the executor, giving him the authority of the court to take possession of the property of the decedent and administer the estate.

Having qualified as executor, the next duty of the trust company acting in that capacity is to advertise the fact that it has been appointed or named executor. The number of papers in which this advertisement must appear, the form of the advertisement, and the length of time that it must be continued will vary somewhat from state to state. The purpose of this advertisement is to give notice to creditors of the estate that the decedent has died and to advise them of the necessity of promptly filing claims for debts due them by the decedent, either with the executor or with the attorney representing the estate, and to advise debtors of the fact of death and to notify them that debts due by them to the decedent should be promptly paid to the executor or its attorney.

During the continuance of the advertisement and thereafter it is the duty of the executor to take possession of the personal assets of the decedent, to have them valued or appraised, and to file with the register of wills what is known as an inventory and appraisement, listing separately and at length all of the items of personal property possessed by the decedent with their value at the date of death. The real property owned by the decedent is not, in most states, included in this inventory and appraisement as real estate is not administered by the executor unless: (1) the personal estate of the decedent is insolvent and it is necessary for the executor to take possession of and sell real estate in order to pay the decedent's debts; (2) it is necessary to sell real estate to carry out the terms of the will, as for example where a decedent made a number of pecuniary bequests and the bulk of his estate consisted of real property; (3) the will directs the executor to take possession of and sell real estate; (4) the decedent has signed an agreement of sale contracting to sell all or some of his real estate prior to his death. In this last case the law considers that an equitable conversion of the property has taken place and for purposes of administration, the decedent having agreed to sell the property although he died before he executed the deed, has converted that property into personalty and dies possessed of the right to receive the consideration therein expressed. Under these circumstances the executor would report that property as being personal property, would execute the deed in favor of the purchaser and receive, account for, and distribute the proceeds as part of the personal estate of the decedent. The inventory and appraisement must ordinarily be sworn to and filed in the register of wills' office.

After filing the inventory and appraisement, and within time limits which are fixed by the various state laws, the executor must make the necessary report of the value of the estate to the state taxing authorities for the purpose of paying the inheritance tax. Most states tax estates of decedents, generally taxing at some percentage rate the net value of the estate at the time of death. The laws of most states provide a time within which the tax must be paid, subject to certain penalties. Within 1 year after death is a customary time period.

If the estate is large enough, it may also be subject to the Federal estate tax. The Federal laws impose a progressive tax upon the net value of estates of decedents. It has an exemption of $100,000, so that to be subject to a Federal tax the estate must exceed that sum. For the purpose of paying this tax it is the duty of the executor to fill in a lengthy form supplied by the Federal taxing authorities.

If the decedent owned real estate in other counties or states than that of his residence, a separate administration of such real estate is made in the county of its location and the taxes on the net value thereof are paid in that county or state.

One of the most arduous duties of the executor is the settlement of transfer taxes when the decedent possessed stock in corporations incorporated in other states. Quite a number of states, seeking income, have imposed taxes on the transfer of such securities, belonging to estates of decedents, to beneficiaries, or heirs, or upon the sale of those securities to any purchaser. Not only do a considerable number of states tax such transfers substantially, but they impose considerable expense and a vast amount of trouble upon the executor by requiring as a prerequisite to the transfer copies of the will, copies of the letters of administration, sometimes copies of the audit and order of distribution by the court. An attempt is being made today to ameliorate this situation by reciprocity provisions among the states. For example, a number of states do not impose this transfer tax against citizens of states which in turn have agreed not to tax the citizens of the reciprocating state. In settling estates of decedents today it is necessary to have an extensive digest or tax service outlining the laws of the 48 states of the Union, explaining the provisions, and pointing out states in which reciprocity provisions occur and those in which they do not.

It is the duty of the executor to pay the debts of the decedent if he is satisfied that such debts are properly due and owing. If the executor has any question in his mind about the propriety of the claim, he need not pay it until ordered to do so by the court. In fact, he runs some risk in paying questionable debts, for if his action is questioned by any of the heirs or others interested in the estate, and it turns out that he has paid debts which were not owing by the decedent, the executor may be surcharged and compelled to reimburse the estate for amounts improperly paid.

It is not necessary for the executor to convert all of the assets of the estate into cash. He may keep them in kind and so distribute them to those entitled to them under the will or laws of the state, provided that such a distribution in kind is assented to by the recipients. If they object to the securities or other property allotted to them, the executor is always authorized to sell such property and distribute the cash, unless, of course, the specific property has been bequeathed in the will.

During the period of administration it is the further duty of the executor to keep an accurate accounting as to principal and income of

the estate, the executor charging himself with all property belonging to the decedent which has come into the executor's possession, claiming credit for all necessary and legal expenses out of principal, charging himself with all receipts of income from securities and other properties during the period of administration and claiming credit for all necessary and proper expenses out of income; and when the period of administration has ended, it is the duty of the executor to file an account in that form with the proper court of the county in which the administration takes place. The laws of most states provide a period of time following the death of the decedent within which such an account cannot be filed, that time period being granted to creditors to file their claims and to the executor for the purpose of carrying out the details of the administration, as set forth above.

The account is again advertised for periods varying with the different state laws, and during the period of advertisement the account is kept at the register's office and may be examined by any creditor or other person having interest in the estate. After the period of advertisement has passed the account is audited before a judge of the proper court, at which time any one having any objection to the executor's account may appear and be heard, and any creditors having claims against the estate which have not been paid may appear and file and prove their claims. As a result of the audit the judge either approves of the executor's account, or orders certain modifications and changes therein, dependent upon whether he has allowed or disapproved of disputed claims. The account being approved, the executor makes a petition for distribution, setting up a statement of the individuals who are to receive the property of the decedent in their respective amounts; and if this schedule is approved by the court, it will order such distribution to be made. The distribution having been made and receipts therefor having been obtained from the parties at interest, the executor's duties come to an end, and by proper petition to the court he may be officially discharged.

Administrator.—An administrator is appointed to wind up affairs of decedents: (1) in case the decedent died intestate, that is, without leaving a will; (2) where the decedent left a will but failed to name an executor therein; (3) where the decedent left a will and named an executor but the executor refused to act, or has died prior to the death of the decedent; (4) or the heirs object to his appointment for valid reasons; (5) where an executor or administrator has died or been discharged before the estate has been fully administered; (6) where litigation is pending on the will of the decedent and it is necessary that

some one take charge of the estate during the litigation period; (7) where the person named as executor is a minor at the date of the decedent's death, the administrator appointed in such a case would administer the estate during the minority; (8) where administration in another county is necessary in the case of grant of letters in some other county or state.

Trust companies may be appointed as administrators under any of the conditions above set forth. They are so appointed ordinarily at the request of heirs or creditors or other parties having an interest in the estate. The various state laws ordinarily specify the individuals entitled to administer the estate of a decedent, but any of those heirs so entitled by law to administer may renounce that right in favor of some nominated trust company which would under those circumstances be named by the court to act.

The main difference in the manner of appointment of executor and administrator is the customary requirement that an administrator file a bond with adequate security conditioned upon the proper administration of the estate. By the laws of most states, trust companies may file with the courts a general bond covering all estates that they may handle, so that the necessity of filing an individual bond in each estate is avoided. In some states, they are subject to examination by the courts as to their financial condition and file with the court annual statements of their condition. As a result of such examination or statement, the courts may, for a given period of time, qualify them to act as administrator and in other fiduciary capacities in that county without the necessity of filing a bond.

Having been appointed, the duties of the administrator differ in no respect from those of executor, there being only the added step in the matter of discharge, of having the bond canceled by the courts, if any bond has been filed.

b. Trustees.—Trust companies may be appointed or named as trustee to take charge of estates for temporary periods of time for the benefit of individual beneficiaries or charitable or educational corporations. Such trust estates arise frequently in respect to the administration of property for the benefit of minors, widows, or individuals considered incapable of handling properly their own estates. The appointment as trustee may be made by will or deed; for example, an individual owning property may transfer such property during his lifetime to a trust company in trust for certain purposes as: to invest the principal, collect the income and pay it in monthly or semiannual or annual payments to relatives or children, or to a home for diseased cats, or for

any other legal purpose. Analogous provisions may be made by will. Decedents may create trusts for the benefit of minor children, for the benefit of their widows, or sisters, or other relatives or charities.

The bank having been properly named and appointed as trustee, either by deed or by will, or by action of the court, as the case may be, fulfills the following duties: In its capacity as trustee, certain property is entrusted to it for management and it is directed to keep that property invested and to collect the income and pay it over for the purposes of the trust. Its first duty, therefore, is the adequate investment of the principal. It frequently happens that the property comes to the trustee already invested, so that the duty of the trustee consists in maintaining that investment, reinvesting such items of principal as it may receive from the repayment of bonds, mortgages, or other obligations, or from the sale of existing securities which in the opinion of the trustee could be invested more profitably in other ways.

Unless the bank is given greater power by the deed or will naming it trustee, it is restricted in these investments to certain securities which have been defined by statute as legal investments for trust funds. Legal investments for trust funds may differ slightly by statutory definition from state to state, but a typical definition is here given in the Pennsylvania statutes of June 7, 1917, and July 11, 1923. They provided as follows:

When a fiduciary shall have in his hands any moneys, the principal or capital whereof is to remain for a time in his possession or under his control, and the interest, profits, or income whereof are to be paid away, or to accumulate, or when the income of real estate shall be more than sufficient for the purpose of the trust, such fiduciary may invest such moneys in the stock or public debt of the United States, or in the public debt of this commonwealth, or in bonds or certificates of debt now created or hereafter to be created and issued according to law by any of the counties, cities, boroughs, townships, or school districts of this commonwealth, or in mortgages or ground rents in this commonwealth: *Provided*, That nothing herein contained shall authorize any fiduciary to make any investment contrary to the directions contained in the will of the decedent in regard to the investment of such moneys.

When a fiduciary shall have in his hands any moneys, as aforesaid, he may present a petition to the orphans' court having jurisdiction of his accounts, stating the circumstances of the case and the amount or sum of money, which he is desirous of investing; whereupon it shall be lawful for the court, upon due proof, aided, if necessary, by the report of a master, to make an order directing the investment of such moneys in real estate in this commonwealth other than ground rents, or in the bonds or certificates of debt now created or hereafter to be created and issued according to law by any other

state in the United States, or by any of the counties or cities of such other state, at such prices, or on such rates of interest and terms of payment, respectively, as the court shall think fit: *Provided*, That no such investment shall be directed unless it shall be the opinion of the court that it will be for the advantage of the estate, and no change be made in the course of succession by such investment as regards the heirs or next of kin of the cestui que trust: and *provided further*, That nothing herein contained shall authorize the court to make an order contrary to the directions contained in any will in regard to the investment of such moneys.

Executors, administrators, guardians, and other trustees are hereby authorized to invest trust funds, in their possession or under their control, in farm loan bonds issued by Federal Land banks or by Joint-stock Land banks, under the provisions of the Act of Congress of the United States of July 17, 1916, and its amendments or supplements; and that such bonds are hereby declared to be legal investments of moneys by executors, administrators, guardians, and other trustees.

A careful analysis of these statutes will disclose the fact that the legislators have little confidence in the business judgment of trustees and have severely limited them in their investments to types of security in which a greater emphasis is laid upon security of principal than upon adequacy of income. These statutes had their origin at a time when most trustees were individuals, and generally lawyers rather than business men. Whether such legislation will remain in force for a long period of time, now that the management of trust estates has been so largely taken over by banking institutions, whose officers and directors are generally experienced investors, is a matter of some doubt. It is the opinion of most thoughtful persons that the statutes unduly hamper the trustee in the proper management of estates for the best interests of the beneficiaries. It could probably be demonstrated that even in the matter of security of principal such statutes overreach themselves and do not even adequately provide what is ostensibly their chief aim. For example, during the period 1914 to 1920, a period marked by a declining value of money, trustees hampered by such statutes found themselves unable to protect the principal value of the estates in their care, measured in terms of purchasing power. During such a period, common stocks, well selected, would be far safer investments than any form of government, state, or municipal bonds, for all income from common stocks has a tendency to increase to offset the declining purchasing power of that income, whereas the fixed rate in dollars on bonded securities shows no such tendency.

These facts are being more widely recognized by the layman as well as the professional trustees, so that today it is becoming more and

more customary for the creators of trusts to override the statutory provisions by providing in the deed or will that the trustee shall not be limited in his investments to the so-called legal investments for trust estates. If such a provision is made, the trustee is, as the words imply, no longer bound to invest the principal as the law dictates, but according to the dictates of his better judgment. Under these conditions, he is in general able to obtain for the beneficiary a higher income without any material sacrifice in safety of principal.

In making investments he is bound to use only his best business judgment in good faith for the interest of the trust estate, and he is not responsible for errors in judgment leading to loss, unless those errors were notoriously gross and of a character which would probably not be made by the average man. There are numerous instances, however, of trust companies in the management of trust estates reimbursing the estate for losses made by their investments, although no legal liability exists, particularly if the estate is a relatively small one and the loss is therefore relatively serious.

It must not be supposed that there is a trifling amount of labor involved in the investment of such estates. Not only must the investments be made with care, and as a result of considerable study of the investment situation in general, and the specific securities to be bought in particular, but the investments must be constantly watched and shifted from one security to another as changing conditions in the investment market or in that of the particular securities dictate. The trustee must watch carefully and act upon the issuance of rights by companies whose securities it may hold. One large trust company, failing to exercise such rights or to sell them within the time allotted by the issue, lost many thousands of dollars which it was compelled to reimburse to the estate.

It goes without saying that accurate accounts must be kept in respect to each estate showing the investment and reinvestment of the principal, the costs and charges therein involved, and the securities must be adequately safeguarded from theft or other loss. This latter provision is ordinarily covered by insurance. Besides the duty of investing the principal, there is the duty of collecting and distributing the income of the estate in accordance with the directions of the creator of the trust. The securities are placed in the name of the trustee trust company or one of its officials, so that dividend and interest payments are made directly to it. They must be accurately accounted for and may be deposited for a temporary period of time in the bank or trust company itself, awaiting distribution, but principal

awaiting investment and funds kept in liquid form for longer periods of time must be deposited in some other banking institution, under the laws of most states.

In the matter of the distribution of income, trust companies, as a rule, go as far as they can to meet the desires of the recipients of that income in the matter of time, place, and manner of its payments, within the limits of the instructions of the creator of the trust under which they operate. For example, if the trust provided that the trust company shall invest the principal, collect the income, and pay it annually to a given beneficiary, the trust company as a rule will pay it monthly or every three months, or semiannually or annually, depending upon the wishes of the recipient and on dates most convenient to the recipient, subject of course to the general rule that they do not pay income which is not earned, although they are frequently willing to pay income which has been earned but not as yet collected.

The laws of most states require the trustee to submit to the courts having jurisdiction over trust estates a periodic account of their trusteeship, showing principal and income, receipts and expenditures. Such accounts may be rendered annually, are audited by the courts, and approved or disapproved and ordered changed, as the case may be. Frequently accounts are not rendered annually; the court will take no steps to see that they are, at any rate in private trusts, leaving that matter to the joint discretion of the trustees and beneficiaries. At the instance of the beneficiary, however, it will order trustees to account at such periodic times.

When the purpose of the trust has been completed, the trustee will file what is known as his final account, summarizing preceding accounts and giving in figures the final status of the estate in principal and income, which he now proposes to turn over to the parties entitled to receive it. Such final account is audited and, if approved, the trustee is ordered to turn over the principal securities and balance of income to those entitled to them and after filing the proper receipts indicating such final payments with the court, will be officially discharged by the court. A charge is made by trust companies for this service, varying with the conditions involved, but being ordinarily a percentage of the income collected, in many cases 5 per cent of such income per annum. The trustee may make a charge for the final settlement of the estate, which is ordinarily a flat figure determined either by the agreement entered into with the company at the time it consented to act as trustee, or in the absence of such an agreement, a charge may be based on the size of the estate and the work involved in its ultimate settlement, subject

always to the review of the court, if, in its opinion, the charge is not justified.

c. Guardians of the Persons and the Estates of Minors.—Trust companies may be appointed by will or by the court as guardians of the persons or estates of minors, or both. It is far more customary to name trust companies as guardians of the estates of minors than to name them as guardians of the persons of minors. There are some obvious disadvantages in having a corporation the guardian of the person of a minor, although numerous instances of such an appointment exist. Of necessity the trust company must delegate most of its activities to schools or other institutions, or paid hirelings where it is acting as guardian of the person, and the constant personal supervision so necessary for the successful training and development of young children would obviously be lacking.

As guardian of the estates of minors, however, the trust company is fulfilling its natural function in the investment and collection of income, and its duties in that connection do not differ from the above described activities of the trust company in its private trusts.

d. Living Trusts.—Trusts may be created by individuals, during their life, for many desirable purposes. These trusts may be made revocable or irrevocable, depending upon the circumstances of the case and the ends to be achieved. A trust may be so arranged that the creator of the trust may receive the income during his life, or the income may be allotted to any other beneficiary either before or after the death of the creator.

In this way independent incomes may be created for the benefit of wife, mother, sister or other desired beneficiary, and the principal can be disposed of in any way desired at some future date. Inheritance taxes and probate and settlement expenses may be avoided, for the trust is a conveyance during life, not subject to inheritance taxes. The trust may be so drawn that additional property may be added to it, and the creator of the trust may retain over it some measure of control. There are innumerable uses for which such living trusts may be created, and these will be explained by the officers of trust departments.

e. Life Insurance Trusts.—The needs of a family after the death of the husband and father should be considered in terms of income rather than of principal value. Many men are deceived in the size of the estate they will leave after death. Inheritance taxes, probate expenses, lawyers' fees, uncollectible debts, etc., seriously diminish its principal value. Widows are frequently inexperienced in the investment of large sums of money and fall an easy prey to speculative stock salesmen. To

meet these dangers, life insurance trusts have been devised. These trusts may take a number of forms, but they have this feature in common, that a bank or trust company is made trustee of the proceeds of life insurance policies, for their investment and distribution. Under the terms of the trust the income may go to the wife for life, the income or principal to pass then to other heirs. In small estates, the trustee may be directed to draw upon the principal in cases of emergency if the income is insufficient.

The trust may be created by making the bank trustee simply of the proceeds of an existing insurance policy or policies, leaving the responsibility for the payment of premiums upon the insured, or the insured may convey to the bank under a trust agreement, cash or securities, the income from which is to be used to pay the premium, and on death both the deposited securities and the proceeds of the policies are trusteed for the benefit of the beneficiaries. For example, if a man has $50,000 of securities bringing in an income of $2,500 a year, he may deposit those securities with a bank in trust to use the income in payment of premiums on life insurance policies. Depending upon his age at the time of taking out the policies, this will pay for insurance in excess of $50,000 more, so that his family is assured of an estate of over $100,000 with an income of at least $5,000 a year.

If a man is a partner in a business, and his estate consists chiefly in his interest in the business, his heirs may be embarrassed in the event of his death by a forced sale of his share. This difficulty may be overcome by insuring each partner for an amount equal to the value of his interest in favor of the other partners, the business paying the premiums. When a partner dies, a fund is immediately created equal to the value of his interest, which is then purchased and the heirs paid without difficulty or delay. A bank may be named as trustee for the purpose of carrying out the provisions of the plan.

f. Escrows.—It is frequently necessary in business transactions to make delivery of deeds, cash, contracts, securities, leases, etc., upon condition, that is, contingent upon the carrying out of certain agreements, generally the payment of the consideration. The trust departments of banks undertake this function for a moderate charge. For example, in real-estate transactions, deeds may be deposited with banks, to be delivered by them to the grantees, when payment is made, or when other conditions are fulfilled.

New Methods for the Investment of Trust Funds.—The investment of small sums in a way to combine safety of principal with substantial income is occasionally a serious problem. At times there may be diffi-

culties in the speedy investment of large sums. Some banks take out mortgages with banking funds, and sell participation certificates in these mortgages to estates, as and when there is principal awaiting investment.

A trust company in New York has recently organized a separate incorporated fund with a substantial capital divided into shares which will be invested in legal investments for trust funds. When the trust company has principal for investment in any of its trust estates, if the creator of the trust has so authorized, the funds may be invested in shares in this incorporated fund, thus assuring immediate investment at a uniform rate of the principal of different trusts. Greater security and diversity of investment can be obtained by thus mingling the funds to be invested and belonging to the different trusts.

Advantages of the Corporate Trustee.—Considerable debate has arisen in various quarters as to the relative advantages of a corporate trustee, for example a bank, compared to an individual trustee. The advantages of the corporate trustee have been stated to be: (1) its permanency—it does not die; (2) it does not go abroad; (3) it does not become insane; (4) it does not imperil the trust by failure or dishonesty; (5) its experience and judgment in trust matters are beyond dispute; (6) it never neglects its work or hands it over to untrustworthy people; (7) it does not refuse to act from caprice or on the ground of inexperience; (8) it is invariably on hand during business hours and can be consulted at all times; (9) its wide experience of trust business and trust securities is invaluable to the estate; (10) it is absolutely confidential; (11) it has no sympathies or antipathies and no politics; (12) it can be relied upon to act up to its instructions; (13) it does not resign; (14) all new investments of value suitable for trust estates are offered in the first instance to trust companies, and in that way it has a choice of valuable security; and as its purchases are on a scale of magnitude, it can usually buy at a rate which is lower than that at which the individual trustee can purchase.[1]

Disadvantages of the Corporate Trustee.—On the other hand, some commentators have raised objections to the trust company as trustee. The advantages numbered 4, 5, 9, and 12, above, are questionable at least, as statements of fact. The chief disadvantage is said to be that the trust company is after all a corporation and delegates its activities to employees who may or may not be skilled in their performance. As a corporation it is ruled to a considerable degree by red tape and may not take the personal interest in individual estates under its con-

[1] KIRKBRIDE, STERRETT and WILLIS, "The Modern Trust Company."

trol that a personal trustee might be expected to show. Trust companies may be more careful of safety of principal than of quantity of income and therefore trust estates managed by trust companies may obtain the minimum rate only, on the amount invested, and the trustee may be willing to take no step outside of the narrow path of its regular corporate activities. In questionable matters it will never act without an order from a court. If the statute law says that legacies need not be paid until the expiration of 1 year after death, a trust company will rarely pay them until the expiration of the statutory period, whereas a private individual might consider the circumstances of the case and make payment in advance of the statutory period.

There are certain advantages in naming as executors or trustees, or both, a trust company and a private individual. In this way the accuracy and security and attention to duty, continual presence, etc., of the trust company can be secured, together with the personal interest, etc., of a private trustee.

References

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CHAPTER XX

CORPORATE TRUST AND ALLIED ACTIVITIES

Trustee.—For many years it has been the practice for corporations issuing bonds secured by mortgages on real estate or the deposit of other collateral security to name one or more trustees of the mortgage, or trustees to hold the other deposited security for the benefit of the bondholders. Originally, it was customary to name individuals to act in this trustee capacity but of recent years trust companies are now ordinarily so named. The advantages of corporate trustees are similar in most respects to the advantages hitherto recited in the case of individual trusts. In addition to these advantages, the name and standing of the trust company assures to bondholders that the details of the issue have been properly handled.

The duties of the trustee are fully set forth in the mortgage or trust agreement, as the case may be. The trustee is not responsible in any way for the value of the securities sold, but investors are fairly confident that the leading trust companies will not permit the use of their name unless they are reasonably assured of the good faith of the transaction and the probable value of the bonds or other securities sold.

If a trust company acts in the capacity of trustee for a mortgage securing a bond issue, the title to the mortgage proper is put in the name of the trust company. If the security is the deposit of securities, they are usually put in the possession of the trust company. The trust company should assure itself through the advice of counsel that the mortgage or trust agreement is properly and legally drawn, executed and recorded. The trust company must make sure that the bonds are issued in accordance with the terms of the mortgage and are in proper form, and before the bonds can be sold the trust company must certify on them that *this bond is one of the bonds described in the within mentioned indenture.*

The trust company should make sure that the mortgage or trust agreement clearly sets forth the rights and duties of the trustee and limits its liability. The liability of a trustee is ordinarily limited to negligent acts on its part. It assumes no further responsibility for the ultimate repayment of the bonds or interest.

The mortgage or trust agreement should specify what rights of action a trustee may have in the event of default of the interest or principal of the bonds. It is customary to give to the trustee the exclusive right of action in the case of default unless the trustee refuses to act.

The mortgage or trust agreement should by its terms properly indemnify the trustee for any expense involved in taking action to protect the bondholders or otherwise carry out the purposes and intent of the trusteeship.

The mortgage frequently calls upon the issuing company to set aside a certain sum for sinking fund to retire the bonds in whole or in part within a specified term. If this provision exists, it is the duty of the trustee to see that the sinking-fund provisions are complied with.

If collateral security in the form of stock-market collateral is deposited with the trustee, it occasionally happens that substitution of collateral is permitted, but in that event the trustee must of course assure itself that the substituted collateral is equally as valuable as the collateral withdrawn.

Other forms of collateral may be used, of which car-trust agreements may be cited as a typical example. Railroad companies or traction companies may finance the purchase of cars or other equipment (in some cases these are called equipment trusts) by the issuance of bonds or certificates secured by the cars or equipment purchased. It is a frequent practice to have the trustee take title to the cars or other equipment and then lease them to the railroad or traction company. The rental is used to pay the interest on the bonds or certificates and to set aside a sinking fund for their ultimate retirement. It is essential that the rental be sufficient to accomplish the retirement of the securities during the life of the cars or the equipment pledged. When the bonds or certicates or trust notes are paid off in full, the cars or other equipment are conveyed by the trustee to the railroad or traction company.

In all cases of corporate-trust activities, the trustee keeps accurate record of the collateral pledged, of the bonds received, certificates of delivery, and bonds paid, canceled and destroyed or returned. For these services the trustee receives compensation at an agreed amount, which may vary with the size of the bond issue and the amount of work required.

Fiscal Agent.—The services of fiscal agent are frequently combined with that of corporate trustee, but may in some instances be separate. Trust companies in acting as fiscal agents for corporations may perform a variety of services, the most frequent being the pay-

ment of coupons, interest, dividends, etc., and the repayment at maturity of the principal of bonds, certificates, or trust notes. In addition, in special cases the trust company may practically act in the capacity of treasurer for its corporate client. The trust company will keep accurate accounts showing the monies received from the client for disbursement and the monies paid out in honoring coupons or in payment of dividends, interest, or principal. The honoring of coupons may be complicated by Federal or state regulations in respect to tax-exempt obligations or ownership certificates, as required by income-tax rules.

Dividends are paid in accordance with dividend lists prepared by the transfer agent, who may be the same company or some other corporation, and the same procedure is followed in the payment of registered interest.

Transfer Agent.—A transfer agent is a corporation or individual authorized to transfer the stock of the company from the seller to purchaser. Corporate stocks are freely purchased and sold, the purchaser of such stock sending the shares purchased with his indorsement to the transfer agent, who will reissue to the purchaser a new certificate of stock, canceling the old.

Such transfer agents may be either the corporation itself or an outside trust company or individual appointed for that purpose. It is quite customary today to name banks or trust companies as transfer agents for corporations.

The transfer agent is generally responsible for nothing but his own negligence. He must be sure that the certificates presented to him for transfer are properly indorsed and that the person owning the certificate has the power to sell under the laws of the state in which the transfer is made, or under the rules of exchanges upon which the sale may have been consummated. If there are any transfer or stamp taxes, it is the duty of the transfer agent to make sure that these are paid and the necessary stamps properly affixed. The transfer agent must keep accurate records of stock issued and certificates returned and canceled, and also a record of the names and addresses of the stockholders and the number of shares belonging to each, from which dividend lists may be prepared. Registered bonds are transferred and a record thereof kept in the same manner as of stock. More than one transfer agency may be established, and this will be true if the stock is listed on more than one exchange or if the corporation, like some of the larger railroad companies, is incorporated in a number of states. In such a case transfers may be made at any agency and it is, therefore, necessary for the transfer agents to notify each other of transfers made.

Registrar.—Registrars came into existence to prevent the fraudulent overissue of shares of stock or bonds by a corporation in excess of the amounts authorized. The rules of the New York Stock Exchange and most other exchanges require that listed stocks shall be registered and the registrar must be a corporation or other agency which is not at the same time the transfer agent for the same corporation. This is logical because it is the chief duty of the registrar to check up the transactions of the transfer agent to prevent overissues. Most shares of stock and registered bonds are valid only if signed by the transfer agent and the registrar. Upon issuing securities, the transfer agent will send them to the registrar to be signed and registered, and canceled certificates and registered bonds will be sent to the registrar for record. The records kept by the registrar must, therefore, check with and correspond with the records kept by the transfer agent. Separate accounts are kept for each class of stock of a corporation. For services as transfer agent, or registrar, the trust company receives an agreed fee.

Voting Trusts.—Banks and trust companies are frequently appointed agents for voting trustees to hold the stock certificates which have been deposited by the stockholders with the voting trustees for the purpose of keeping the control of the company and its policies in the hands of a certain group. The stockholders receive in exchange for their certificates voting trust certificates which are issued to them and transferred in case of sale by the bank or trust company in its capacity as agent. The bank or trust company may also distribute the dividends declared on the stock to the holders of the voting trust certificates.

Assignee and Receiver.—Corporations or firms in financial difficulties may make an assignment of their assets to a bank or trust company for the purpose of protecting the interest of the creditors. The duties of the assignee in each case will be determined by the terms of the assignment. Frequently its chief duty will be to collect the assets of the assignor in an orderly fashion and distribute these assets to the creditors who properly prove their claims. For the purpose of orderly liquidation, it may be necessary to conduct the business for some period of time until its assets can be advantageously sold, and in some instances the conduct of the business may result in such an improvement in its financial condition that ultimate liquidation and distribution of its assets may be unnecessary and it may be turned back to its owners with the consent of its creditors and continue as a going concern.

The bank may act in a similar capacity as receiver for companies in

financial difficulties. The term *receiver* comes into use primarily when the assignment is not made by the voluntary act of the owners of the business but when as a result of court proceedings the bank or trust company is named as receiver by a proper court. It is of course necessary for the trust company, either in the case of an assigneeship or a receivership, to keep accurate accounts of its management of the business.

Miscellaneous Activities.—Trust companies may undertake the care of securities for individuals or corporations. Such custodianship of securities most frequently arises in the case of individuals who wish to be relieved of the responsibility of attending to their property. The trust company for such individuals will analyze their security holdings, making suggestions for altering them if, in the judgment of the trust company, changes would be advisable; will hold the securities subject to the order of their owner by mail, telegraph, or cable; will advise the owner of maturing bonds or called bonds, of the issuance of rights and other valuable perquisites attached to ownership, and will, on behalf of the owner, collect the principal of such called bonds, reinvest, and sell or exercise rights to subscribe, etc. The trust company will clip coupons, receive dividends and interest payments and credit them to the owner's account, or remit, as the case may be, and will keep a record of the income for income-tax purposes. The trust company will sell the securities through brokers upon the request of the owner.

The bank or trust company may act as a depositary of defaulted securities under plans of reorganization, giving in exchange therefor certificates of deposit; and the bank or trust company will aid in carrying out any plans of reorganization which may be formulated.

The Investment Department.—Many urban commercial banking institutions operate investment or securities departments which buy and sell securities for the account of the bank, as well as for its other customers, who usually consist of depositors in the bank. The securities are sold by methods similar to those used by investment banking houses, either directly over the counter, by correspondence, or through salesmen. They are purchased through the regular investment channels or are acquired by participation in an issuing syndicate. In such activities the bank or trust company may be only a member of the underwriting syndicate or in some cases may be the syndicate manager. In the latter case, the corporate trust department is ordinarily the department which handles the details of the work.

Investment Security Dealings by National Banks.—Prior to the passage of the McFadden bill, national banks had no power to enter

underwriting syndicates or to deal in investment securities in any other capacity than as a purchaser of bonds for investment of banking funds. Because of this limitation upon their activities a number of the larger national banks organized separate companies to carry on the business of dealing in stocks and bonds. Separate companies could also open offices in other states, which was forbidden to national banks.

Under the terms of the McFadden bill, the right of national banks directly to deal in investment securities was granted by the following provision, which is an amendment of Sec. 5136, United States Revised Statutes, in which the general powers of national banks are specified:

> *Provided*, That the business of buying and selling investment securities shall hereafter be limited to buying and selling without recourse marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation, in the form of bonds, notes, and/or debentures, commonly known as investment securities, under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency, and the total amount of such investment securities of any one obligor or maker held by such association shall at no time exceed 25 per cent of the amount of the capital stock of such association actually paid in and unimpaired and 25 per cent of its unimpaired surplus fund, but this limitation as to total amount shall not apply to obligations of the United States, or general obligations of any state or of any political subdivision thereof, or obligations issued under authority of the Federal Farm Loan Act: *And provided further*, That in carrying on the business commonly known as the safe-deposit business, no such association shall invest in the capital stock of a corporation organized under the law of any state to conduct a safe-deposit business in an amount in excess of 15 per cent of the capital stock of such association paid in and unimpaired and 15 per cent of its unimpaired surplus.
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> But no association shall transact any business except such as is incidental and necessarily preliminary to its organization, until it has been authorized by the Comptroller of the Currency to commence the business of banking.

The Comptroller of the Currency, as of June, 1927, issued the following regulations defining investment securities:

> An obligation of indebtedness which may be bought and sold by national banks, in order to come within the classification of "investment securities" within the meaning of the proviso of Sec. 5136 above quoted, must be a marketable security as designated by the express language of said proviso. Under ordinary circumstances the term "marketable" means that the security in question has such a market as to render sales at intrinsic values readily possible.
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> In classifying a given security as marketable, the Comptroller of the Cur-

rency may in specific cases give consideration to various facts and circumstances, but he will require in all cases the following:

a. That the issue be of a sufficiently large total to make marketability possible.

b. Such a public distribution of the securities must have been provided for or made in a manner to protect or insure the marketability of the issue.

c. That the trust agreement under which the security is issued provides for a trustee independent of the obligor and in the case of securities issued under a trust agreement executed and delivered after 60 days from the date of the promulgation of these regulations, such a trustee must be a bank or trust company.

This series of regulations may be modified, amended, or withdrawn at any time by the Comptroller of the Currency.

State Banks.—In respect to state banks, the right to buy and sell investment securities has generally been considered as part of their general banking powers. Chiefly for freedom in establishing offices in other states, a number of the larger state banks have also organized subsidiary companies to carry on their investment business.

The investment department renders valuable service to the customers of a bank, by analyzing the holdings of the customers. To facilitate this work, a statistical department is usually operated. This department also assists in selecting investments to be handled by the investment department. When this department participates in a syndicate operation, it sells the securities allotted to it to the bank itself for its permanent account, and to its correspondents and regular customers. This type of business is frequently a source of considerable revenue to the department.

Affiliated Investment Corporations.—The growth in the size and resources of the so-called commercial banks, together with certain economic tendencies in the commercial banking field has led to the formation of affiliated corporations to engage in the field of investment banking. It is apparent that separate corporations with wide powers can engage in many operations, which under the laws cannot be directly participated in by commercial banks. The creation of affiliated investment corporations also enables the opening up of branches in any state or county, and thus permits a wider distribution of securities and a larger volume of business than would be possible if only an investment department of a bank, prohibited from widespread branch banking, was operated.

The oldest of this type of organization in this country, the National City Company, was incorporated under the laws of New York in 1911,

to conduct a general investment business. Later, in 1916, it took over the investment firm of N. W. Halsey & Company and today operates branches in large cities in this country and abroad. Other large New York banks also created affiliated investment organizations, notably the Chase Securities Corporation in 1917, and the Guaranty Company in 1919. Today many large urban institutions operate separate investment corporations. The capital stock of the National City Company was issued under a trust agreement in favor of the stockholders of the National City Bank, whose beneficial interest is evidenced by indorsement on the National City Bank shares. This is due to the prohibitive sections of the national banking act referred to in the early chapters of this book. The Guaranty Trust Company owns and holds the stock of the Guaranty Company as an investment.

The functions of these investment corporations are similar in nature to those of the private investment banking houses. They originate, underwrite, and participate in both the wholesale and retail distribution of securities. In addition, they facilitate the efficient operation of the commercial bank itself by rendering many services to it and its customers. They will enable the bank to buy securities which have been thoroughly analyzed. They will assist the customers of the bank by advising them in their investment programs and render like services. In many cases, these companies have purchased and held real estate for the bank until the latter wishes to actually make use of it. They operate, as a rule, extensive research and statistical departments, which are for the use of their customers as well as for their own operations. They have been of material assistance in facilitating the mergers, consolidations, etc., that have taken place. Frequently the branch offices of the investment company will act as correspondent offices for the banks, and thus aid in building up the business of the bank. They have also frequently invested in the shares of stock of other commercial banks, and thus created an interest which later on might be developed.

The greater freedom of action allowed affiliated investment corporations, as contrasted to investment departments operated by commercial banks, will no doubt lead to the further development of this tendency in modern commercial banking practice.

Affiliated Trust Companies.—It is sometimes found expedient to carry on the business of a trust department by a separate corporation. Recently the National City Bank affiliated with the Farmers' Loan and Trust Company and formed a new corporation named the City Bank Farmers Trust Company.

The City Bank Farmers Trust Company represents a consolidation of the trust organizations of the National City Bank of New York and the Farmers' Loan and Trust Company. Its stock is trusteed for the benefit of the shareholders of the National City Bank of New York and their beneficial interest will be evidenced by an indorsement on the stock certificates of the bank in the same manner as their beneficial interest in the National City Company is now evidenced.

The City Bank Farmers Trust Company with a capital of $10,000,000 and a surplus of $10,000,000 will operate under the 107-year-old charter of the Farmers' Loan and Trust Company. It will be administered by a separate board of directors composed of trust-minded and investment-minded men of recognized calibre. The executive officers will be men of experience in the handling of trust business, being drawn from those who have handled similar work in the merged institutions. The chairman will be the Chairman of the National City Bank of New York, the president will be the former President of the Farmers' Loan and Trust Company.[1]

Other Affiliated Companies.—The safe deposit business and the business of title insurance may be carried on by separate corporations whose stock is owned by the parent bank or banks or trusteed for the benefit of the shareholders of the bank or banks as the case may be. Recently, in Philadelphia, a number of banks cooperated in organizing a title insurance company to conduct that activity for the joint benefit of the banks in the plan. It centralized the work, eliminated some competition, and made a stronger company whose policies would be more highly valued than the policies issued by any of the smaller banks in the organization.

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CHAPTER XXI

THE NEW BUSINESS DEPARTMENT

The growth of a banking institution is largely dependent upon obtaining new accounts and new customers, and therefore increasing interest has been drawn to methods devised by banks to increase their business. Certain practices have been in vogue for years in the development of the business of a bank, while more recently many large urban institutions have found it profitable to organize and operate a separate department usually designated the New Business Department, for this work. It has been recognized by most banks that the following practices encourage the development of new business contacts.

Stock Distribution.—Stockholders should, in the normal course of events, be customers of the bank, whether as depositors or borrowers, or both, and for this reason it is felt that a wide distribution of stock is advantageous for enlarging the business of the bank. Such a wide distribution of stock cannot, of course, be arbitrarily obtained, but circumstances frequently arise in which the officers or directors of the bank can influence the purchase or sale of stock for the purpose of extending the stockholding interests in profitable quarters.

Comparatively few banks have listed their securities on local exchanges, and most sales of bank stocks are either privately negotiated by brokers who specialize in such securities, or are offered for sale at public auction by stock auctioneers. In both cases it is customary for the brokers, whether handling the stock through private sale or public auction, to notify the officials of the bank that blocks of its stock are held for sale at certain minimum prices. The officers and directors are in this way given an opportunity to purchase the stock; or to suggest to friends or business acquaintances its purchase and thus increase and diversify the stockholders.

For example, some years ago a retiring president of a large New York bank announced to the board of directors of that bank that he intended to dispose of his holdings of several million dollars of its capital stock. This presented to the board a number of practical problems

for solution. The offering of such a large block of stock would have a tendency to depress the value of the stock in the financial markets, and such a fall in value might react unfavorably upon the business of the bank and the confidence of other shareholders. Again, the purchase of such a large block of stock by one or two wealthy interests might place a preponderating control over the activities of the bank in unfriendly hands.

A number of possibilities immediately suggested themselves. The directors and officers might individually or as a group purchase the stock; in other words, form a pool to acquire this large block and protect the price of the stock in the market. But such a procedure would, in the first place, be expensive, and, in the second place, would add nothing to the business of the bank, for the officers and directors were already presumably dealing with the bank as extensively as their financial and business activities justified.

After considerable debate, the board of directors decided that the position of this New York bank was already sufficiently established within that city to make additional stockholding interests therein unnecessary; but that the agency and foreign financing business of this bank were susceptible to considerable growth, and might be encouraged by a wide stockholding interest in various parts of the United States where shippers and other business men might need New York banking facilities for export or import purposes. The directors therefore organized a company to retail the stock in selected centers in the United States outside of New York in relatively small lots. Practically the entire block was disposed of throughout the West, and it was so well done that the price of stock actually rose during the process of sale.

This serves to illustrate among other things the importance attached by the board of directors to a proper stock distribution from the standpoint of attracting new business to the institution.

Stockholders should be customers of the bank in which they own stock, and the officers of the bank should therefore periodically examine their stockholders' accounts, ascertain whether or not there were local stockholders who did no business with the bank, and if that is the case solicit these stockholders by mail, pointing out the fact that their proprietary interest in the bank should enlist their active participation in the bank's business.

It is proper also to solicit stockholders who are depositors or customers of the bank to increase their accounts and activity of their banking connection, and to enlist their friends in building up the bank's business.

Directors and Officers.—Directors, and to some extent officers, should be chosen with a view to attracting new business. With that in mind, directors are selected from among the ranks of prominent business men representing different businesses, and different sections of the community, and if the bank is a country bank doing business over a relatively large geographical area, representing different outlying towns. One or two lawyers almost invariably appear as members of the bank's board, particularly if the bank has a trust department, for lawyers are constantly called upon by their clients to draw up wills in which executors and trustees are appointed, to draw up deeds of trust in which trustees are named, procure guardians for minors, etc., and in all of these matters lawyer directors will properly throw their influence for obtaining for the bank these fiduciary posts. Lawyers are frequently able to obtain from their corporate clients the appointment of their bank as corporate trustee in corporate bond issues.

Business men are expected to bring deposits to the banks from the business with which they are connected, and from business associates and friends. The personnel of the directors should therefore be seriously considered. Good *mixers* and *joiners* are advantageous members of the board, as their wide acquaintanceship may lead to extensive additions to deposit and borrowing accounts. Directors ordinarily recognize this responsibility to obtain new business, as well as to direct the affairs of the bank along managerial lines. Some years ago, at a meeting of the board of a well-known New York national bank, the directors pledged themselves to increase the deposits of the bank by $10,000,000 within the next 6 months through personal solicitation and business associations, and in this they were successful.

Employees.—The attitude of the personnel of the bank towards its customers is a matter of supreme importance both in keeping the depositors and clients of the bank, and in obtaining new business. All of those officers and employees who come in contact with the public, chiefly the tellers and loan officers, should be individuals of pleasing personality, well dressed, friendly and sympathetic in their relations with the clients of the bank. They should learn as rapidly as possible the names of all of the depositors, so that they can recognize them at once and greet them with a friendly " Good morning." This is particularly important in regard to the female depositors, whose business connections run almost invariably along the lines of personal feeling.

A political connection in the personnel of the bank is often important. Such connections may secure substantial deposits from state and municipal sources.

Tellers should go out of their way to accommodate customers in the matter of advice and instruction concerning the drawing and indorsement of checks, the making up of deposit slips, and other small technical matters of that kind. Incidentally, the refusal of a teller to cash a check at 3 : 15 p.m. in one instance almost brought the bank to ruin. The bank was located in a foreign section, and a large proportion of its depositors were Italians. One of them came in and sought to cash a check a short time after the close of the bank's hours. The teller, without making any explanation, refused to cash the check. The depositor went out among his friends that afternoon and evening, and informed them that he couldn't get his money out of the bank. The next morning, a line of 400 Italians was besieging the bank's doors, for the withdrawal of their accounts, thinking that the bank had failed. While this situation is, of course, comparatively rare, it nevertheless emphasizes the fact that courtesy and consideration are due to customers, even after banking hours, and even if the service is refused, a careful and pleasant explanation of the reason of the refusal should accompany it. The same attitude is the one which should be adopted in the matter of turning down loans. An unsafe loan should, of course, be refused, but the method of refusal should be of a character which will not tend to drive clients away from the bank. By the adoption of a proper attitude, a loan officer can at one and the same time turn down a loan and keep a friend.

The problem of personal acquaintanceship between the banking staff and its customers is becoming peculiarly acute as the banks consolidate and grow in size. A very definite danger lurks in this, as many people prefer to deal with a bank in which they are personally known, and receive a considerable amount of personal and social attention that becomes increasingly difficult as the bank grows in size and the number of its depositors and other customers increases. Some of the smaller banks are taking advantage of this recognized fact by advertising that they are small enough to give personal recognition and attention to their customers. This disadvantage of the larger institutions can be to a considerable degree overcome by careful attention and strenuous effort on the part of the tellers and officers to recognize and greet the bulk of their depositors and other clients.

Bank Notes.—The question frequently arises as to why national banks continue to issue notes. Calculations of the Comptroller of the Currency indicate that with the ruling price of bonds securing circulation, the actual profit to the bank is ridiculously small. In the face of this, one of the reasons frequently advanced explaining the position of

the national banks in continuing their note issues is that the notes constitute a mode of advertisement bringing the name of the bank before the public. The authors mention this because the popular claim is advanced in many quarters that this mode of advertisement has some, even though slight, advantage. It seems highly doubtful whether any direct advertising value results from the issuance of bank notes. The average person looks solely at the number in the corner of the note, and not at the name or superscription on its face.

Building Location and Branches.—A handsome, well-equipped, and conveniently located building attracts customers. Recognizing this fact, the banks of today are spending, in some cases, excessive sums of money in constructing buildings of an imposing character. The general emphasis in the past has been laid upon safety and stability, and for that purpose the type of architecture has ordinarily been massive, with windows and doors heavily barred. This has always been primarily an advertising feature, as the real security consists of a properly constructed vault, and adequate insurance protection rather than bars at the windows and doors. Today, a number of the banking institutions have discarded the heavily barred doors and windows and have gone in for window display advertising.

The location of the building is extremely important, both from the standpoint of advertising and of convenience. Corner locations are advantageous because of their convenience of access, additional light, opportunities for display, and the appeal which they may make to a double flow of traffic. Neighborhood business is a very large factor in the activities of any bank, and banks should therefore be conveniently located near their largest customers, if possible. This element of nearness is important because it saves customers' time in going to and from the bank and business, whether making deposits or other bank dealings, and it diminishes the risk of theft in going to and from the bank, which is peculiarly important if large deposits are made in cash or if large sums are periodically withdrawn for payroll purposes. Many of the banks are to a considerable degree counteracting the disadvantage of distance in this respect by providing armored cars for the convenience of their customers in carrying large sums of money, either for deposit or payroll purposes.

Another method, recognizing the importance of nearness to customers, is the location of branches at strategic points, particularly in rapidly growing neighborhoods.

A modern tendency in American banking is to lay emphasis on the aspect of size, and to that end consolidations are rapidly taking place

with the chief aim in view of increasing the resources of the banking institution. While there may be some disadvantages resulting from this practice, such as diminishing personal contact with customers, which has been mentioned above, and increased executive difficulties of supervision and control, nevertheless it is very generally felt that there are offsetting advantages which outweigh these potential disadvantages. It has been claimed that the consolidated institutions can be operated with greater economy, although it is doubtful whether this claim has been substantiated as yet, materially, inasmuch as it is a frequent practice to retain upon consolidation the entire personnel of the consolidating institutions. However, by such consolidation, strategic branches can be obtained and new business may be attracted by the increase of size and prestige of the consolidated institution. This subject will be elaborated upon in greater detail in the chapter on Branch Banking.

Special Services.—Banks obtain a considerable amount of new business through the rendering of special services, gratuitously or otherwise. These special services today are quite extensive and no effort will be made to enumerate them all. Among the more important, however, are the following:

a. Financial Advice.—Customers obtain considerable financial and business advice from their banks. Whether this advice is worth anything or not is a matter of debate, but for the purposes of this chapter it will be assumed that it is valuable. Those banks whose officers are best qualified to give such advice necessarily attract considerable business. Some banks have shown a tendency to specialize among large business activities, so that a given bank will obtain the bulk of the wholesale cotton, wool, and leather accounts in its community, and its officers will be recognized as specialists in these business activities. It is, of course, asking too much of the average banking staff to expect that its officers will be skilled in the financial conduct of a large line of business activities; such business supermen are rare, to say the least, so that a certain degree of specialization would seem to be advantageous. For example, the loan officers of a large bank specializing in the cotton trade are able to recognize the meaning and significance of financial reports of cotton companies as a basis for the extension of lines of credit. The fact that such an officer has examined analogous statements of dozens of successful companies along that line will undoubtedly put him in a position to give financial advice of considerable value to other companies of the same character. But to expect a bank president to be familiar with the special financial

requirements of all types of business is on the face of it unreasonable.

Coupled with the giving of financial advice is the performance of actual clerical and other services in the matter of tax reports, loan reports filed with Federal or state taxing authorities, etc. For example, certain of the larger banks set aside one or more of their staff for some months prior to Mar. 15 of each year who do nothing but assist customers of the bank in the preparation of their income-tax returns. This has become so burdensome to the banks, which make no charge for this service, that the Federal government has come to their assistance and upon request will now furnish to the banks Federal agents to carry on this activity.

b. Credit Information.—Banks are supposed to furnish a certain amount of credit information for the benefit of their customers, particularly from foreign sources, if their customers are exporters or importers. It is stated that the English and German banks through their foreign affiliations perform invaluable services of this character to the big British and German trading houses.

It is obvious that the banks are put in an extremely embarrassing position if credit information is sought concerning their own clients and depositors, whose relationship with them is in a sense confidential. Considerable tact is required in handling this situation.

c. Safe Deposit Business.—Most banks today maintain a Safe Deposit Department which may be simply a department of the bank, or a separate corporation, the stock being owned by the bank itself; or, if that is impossible under state or Federal laws, by the stockholders of the bank, and carrying on business at the same premises. There are some advantages in this dual incorporation in that the capital, surplus, and assets of the bank are not by the latter process involved or tied up in the success of failure of the safe deposit activities. The performance of safe deposit services has considerable advertising value and banks should maintain convenient, well-equipped, and well-lighted vaults under the control of courteous and intelligent employees. Individuals taking advantage of that service, if not already customers of the banking department, as such, are likely to become so.

d. Stock and Bond Department.—Many of our large banks perform valuable and extensive services for their customers, generally without charge, in the matter of the safe-keeping of securities, collection of interest and dividends thereon, crediting these collections to the deposit accounts of the customers, keeping the customers advised in the matter of the declaration of stock dividends, the issuance of valuable rights,

consolidations, bond principal repayments, etc. The banks, for their customers, will handle the details of payment for stock under rights, or the sale of the rights if they are not to be exercised. The banks, through their brokers, will negotiate for their customers the sale, purchase, and transfer of securities.

e. Trust Activities.—This subject is covered in detail in other chapters. It is sufficient here to note that considerable banking business is obtained through the successful practice of trust functions.

f. Title Insurance and Real Estate.—Like the trust activities, these will be discussed in detail in other places in the book, but the services rendered in this connection create customers for the bank who may become depositors and borrowers from the Banking Department.

g. Savings Department.—The general work of this department will be discussed in a later chapter. However, it should be noted that this department can be utilized in developing contacts which later on may bring in profitable customers of the commercial department of the bank. The growing popularity of Christmas Clubs and Vacation Clubs have brought in a host of new customers to the banking organizations of this country.

h. Subsidiary Corporations.—Banks increase their business extensively today by organizing building and loan associations, finance companies, mortgage companies, etc., for the mutual interchange of business. These companies may or may not occupy quarters in the bank, but they operate hand in hand with the banking officials who generally hold official positions in the subsidiary corporations.

Bank Statements.—In so far as the public is concerned, a bank's progress is revealed by the study of the statements which it issues periodically. The use of the bank statement has been discussed elsewhere in this volume, but it should be pointed out that statements possess a certain value, as means for stimulating the interest of the public in the bank. This is particularly true, if the modified statements prepared for the lay public are arranged in a manner which will enable the usual reader to readily grasp their significance. The use of comparative statements indicating the growth of an institution have been found valuable in advertising its progress.

New Business Department.—The growing tendency on the part of large urban banking institutions to operate New Business departments has usually resulted in the rapid growth of such institutions. Some bankers go so far as to compare the work of the New Business Department with the work of the selling department of an industrial concern. Many institutions which have not yet opened up New Business depart-

ments will employ one or more officials, who are exclusively occupied in securing new accounts. Such officials are chosen because of their affiliations and their ability to be good mixers.

An active New Business Department will engage in a variety of tasks. It will often actively solicit new business, have charge of the advertising done by the bank, and supervise the employment, placement, and education of the staff of the bank.

The New Business Department will formulate plans for campaigns and in connection therewith it will utilize the services of the officers and directors of the bank as well as the employees connected with the department itself. In some cases the New Business Department has supplied all the employees of the bank with cards on which the employees themselves are supposed to enter the names of likely prospects, who will then be investigated by the New Business Department. Some banks have found it profitable to issue novelties, such as key cases, clocks, or memorandum books, although this method of attracting business is frowned upon by many conservative bankers.

The New Business Department will frequently conduct a survey of the customers of the bank, with the idea of determining why certain accounts have varied greatly in amount, and why the bank has lost depositors and borrowers. This is just as important as getting new accounts.

Many bankers realize the fact that the young depositors of today will be valued depositors a few years hence, and in addition will often develop into a profitable source of revenue to the bank by using the institution to finance their credit needs. Incidentally, during this present era of abundant credit resources in this country, bankers are constantly on the alert in securing new avenues for advancing credit, because the profit of a bank is dependent not only on securing deposits, but, in addition, safely lending out the credit thus secured to borrowers who meet the exacting requirements of the institution. It is very important for a bank to have contact with successful business enterprises so that they may utilize its credit facilities to the utmost. It is the work of the New Business Department to investigate the territory in which the bank feels it can legitimately operate, with the purpose in mind of securing new customers for the credit of the institution.

Perhaps the devices that have been most successful in encouraging savings accounts have been the Christmas Clubs; and the recently introduced Vacation Clubs, which are organized for the purpose of encouraging savers to put aside and deposit in the Savings Department of the bank a stated sum per week which, within a period of 12 months,

will equal an amount large enough to enable the depositor to pay the expenses of Christmas or a vacation. The banks have found that this not only builds up the savings during the period when the deposits are being made, but it also inculcates habits of thrift in many individuals who otherwise would not deposit with the particular bank, and quite frequently it results in savings accounts of a more permanent nature than are either the Christmas funds, or the Vacation accounts themselves.

This department usually has charge of the advertising done by the bank, either directly or through an agency. In some cases banks have found it of considerable value to issue monthly bulletins containing short, pithy articles on subjects of current interest, or articles showing the trend of business. The National City Bank of New York issues a very elaborate letter of about 15 pages, in which general business conditions are reviewed at some length, and in addition often discusses the leading national and international economic events of the month. The Corn Exchange National Bank and Trust Company of Philadelphia issues a monthly publication of four pages or so consisting of three or four short articles on subjects of interest to Philadelphians.

Some institutions publish special literature which appeals to certain classes of the community. Thus, for example, one large city bank published a very elaborate pamphlet consisting of revised "Mother Goose Rhymes" for the purpose of encouraging children to save and deposit with that particular institution. In addition to these specially prepared periodicals, there are syndicated house organs utilized by a great many banks, though it is doubtful whether these are of value.

Generally speaking, the banks utilize for their advertising purposes the daily and weekly newspapers, financial journals and magazines, billboards, and special letters, in addition to the periodicals described above.

One midwestern bank utilized the radio for advertising its services to the public. However, with the raising of the standard of radio concerts by some of the larger broadcasting organizations, it is questionable whether radio advertising, done on a small scale, has paid. In some cases it has been found that radio broadcasting has tended to irritate as much as to interest when the programs have not been of the highest type.

Banks have also found it profitable to utilize display windows as a means for advertising their services. One particular bank found its business increased when it displayed in a window a very elaborate collection of coins of the United States and foreign nations. Other banks

utilize display windows for the purpose of illustrating the profitable results of saving.

Night banking has become increasingly popular in this country, and in cases where banks have not felt it advisable to operate on a 24-hour a day basis, they have built into their offices a conveniently located receptacle known as a *Night Depository* into which the depositor can at any time insert the currency or checks deposited with the utmost safety. The banks provide for the depositor who anticipates the necessity for making deposits at night, a special sack equipped with a lock, in which the passbook and the cash to be deposited are placed, and a set of keys to open the *Depository.* The *Depository* leads to a special burglar-proof combination vault which is opened the next morning by the proper officials of the bank.

Perhaps the most common method for attracting new business to banks in this country is the development of the services rendered to a depositor. Today, banks provide elaborately furnished rest rooms for customers, and do all in their power to reduce the amount of labor incidental to doing business with the bank. Many banks provide mechanical devices for the purpose of lessening the amount of work necessary in totaling the deposits to be made by the customers.

Needless to say, as competition increases in the banking business, so will the work of the New Business Department become of greater importance. When the competition is keen, the bankers must devise original methods and means in order to keep sufficiently ahead of their competitors, and the New Business Department is the logical department for developing this phase of the banking business.

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CHAPTER XXII

PERSONAL LOAN, SAVINGS, AND SAFE DEPOSIT DEPARTMENTS

Personal Loan Department.—It is a growing practice among commercial banks to study carefully, the feasibility of opening up a department for the purpose of extending small loans to the salaried man and the wage earner. This type of finance is called by various titles, among which the more commonly used are *industrial finance, workers' finance, household finance*, and *family finance*, as well as *personal finance.* The many institutions in this country which have been created specifically for the purpose of extending small loans to salary and wage earners are in almost all cases called *industrial lenders' corporations.* Commercial banks which have created departments to handle small loans usually designate these departments as *personal loan departments.* The National City Bank in New York, the Shawmut National Bank in Boston, the Mitten Bank and Trust Company in Philadelphia, are all commercial banks which have opened up personal loan departments.

These departments operate under the jurisdiction of the state banking departments, and therefore the rates of interest charged the borrower are based upon the bank statutes and not upon the Uniform Small Loan Act. In most cases, such departments will lend upon the security of a note signed by the principal and two comakers up to a maximum of $1,000 for 1 year's time. The discount rate is 6 per cent, which is deducted for the full period of the loan. Very often banks will charge an investigation fee of approximately 2 per cent in addition to the 6 per cent discount. Then, the borrower is encouraged to open up a special deposit account in which he makes periodical deposits at the rate of at least 2 per cent per week, and pledges the pass book as additional security for the loan which formerly had been granted to him. In some cases this deposit is mandatory; in other instances it is conditional, in order to avoid the appearance of usury in regard to required balances. Thus, in effect, the loan costs the borrower more than the 6 per cent interest charge, and the 2 per cent investigation fee, because he has paid interest on the total loan for the full life of the loan,

while in fact he is gradually depositing with the bank amounts which, if the loan happens to be a yearly loan, will mature the loan in 50 weeks. In some cases, the banks will pay the borrower, in turn, interest on the special deposit accounts. In the case of one of the large American banks, interest is paid at 3 per cent, compounded monthly, on such deposits.

One of the large national banks of this country engaged in the personal loan business insures the borrower without additional cost to him, and then takes out a blanket policy on all borrowers to protect itself.

The methods in vogue for analyzing the personal loan risks are similar. As a rule, the basis of information is the application form which provides information concerning principal and comakers. On this filled-in form, the borrower's name; age; marital status; residence, place and length; occupation; position; term of employment; previous employment, place and length; weekly earnings; other income; rent, amount and to whom paid; insurance, and beneficiary; real estate, values, encumbrances, and title status; etc., are asked for. The borrower is asked the purpose for which he is requesting the extension of credit, and in many cases is required to give credit references. The information regarding the comakers is less detailed than that asked the borrower. The lending institution will usually confirm the truth of some of the answers to the questions on the questionnaire, particularly as far as employment is concerned, and also concerning the amount of rent paid by the prospective borrower, to be used as an indication of his fiscal habits, and often inquiry is made as to whether or not the rent is paid promptly. It is not the usual custom in the case of smaller loans to follow up the references, and therefore most emphasis is placed upon the personal character, which is often judged by steadiness of employment, length of employment, length of residence in a particular place, ownership of real estate, and facts of that nature. One bank makes a rule that borrowers shall not borrow more than 10 per cent of their annual income, if married, and in one case preference is made as regards the nationality of the borrower.

There is no general agreement among bankers as to what constitutes a legitimate purpose for obtaining small loans. In the main, it has been considered that any useful or practical purpose enabling the borrower to meet an emergency or to improve his position in life is a proper reason for securing credit.

The turnover in the personal loan business is a very important factor, and any delinquency on the part of the borrowers in making deposits is carefully watched and checked. In one case the personal

loan department of a national bank sends two notices to the principal that he is delinquent in payment, and if the borrower pays no attention to these notices a third one is sent, stating that the comakers will be called upon. The comakers in turn receive copies of this notification and in most cases this is found an effective method by which the comakers themselves will help to bring pressure to bear upon the delinquent borrower, because they foresee the costly result to themselves if the borrower continues to remain delinquent. In the experience of one bank engaged in the business of making personal loans, it was found that delinquencies rarely exceed 5 per cent of the number of loans, while the losses are but 0.1 per cent of the amounts of the loans, although a reserve of 0.25 per cent is provided by this particular institution.

Commercial banks engaged in the personal loan business are aware of the value of having responsible comakers sign the notes of the borrowers, because this not only affords the bank additional security in case of delinquency of the borrower, but, more important, it tends to influence the borrower through the medium of the comakers.

That the business of granting personal loans is a legitimate form of business for the commercial banks to undertake is beyond question at the present time, and it is probable that within the next decade or so most of the large commercial banks of this country will engage in the personal loan business. The reasons influencing the banks to undertake this activity are numerous. At the rate of interest customarily charged, the department can be operated at a profit if the credit investigation is carefully made and the losses held down to a minimum. A certain number of the small borrowers may so improve their financial condition that valuable business and checking accounts will result from the good will established. It is the aim of the department to encourage habits of thrift and in many cases the deposit of small weekly sums will continue after the loan is paid off and result in growing savings-fund deposits. In the case of the National City Bank, the officials have expressed the hope that these savings accounts, when large enough, will be utilized to purchase bonds in small denominations and so furnish a growing market for the retail operations of the National City Company.

The National City Bank, during the first 20 months of its operation, made 119,987 loans, totaling $41,745,039, an average of $347.92 each. Following is a list showing the classification of all those who obtained loans.[1]

[1] Speech of Roger Steffan, vice-president National City Bank, at Eastern Regional Savings Conference, New York, Mar. 20, 1930.

	Per cent
Clerical employees	22
Salesmen	13
Public employees (Federal, state, city)	10
Department heads	8
Mechanics	7
Storekeepers	6
Drivers and truckmen	6
Business men (owners)	6
Professional men	4
Business men (partners)	2
Foremen	2
Corporation officers	1
Miscellaneous	13

Emphasis should be laid upon the necessity of obtaining a competent department head. The nature of the credit investigation differs materially from the credit analysis required for commercial loans. A sympathetic understanding and an ability to read character from personal interviews are the primary requisites from the credit side, and in addition, new business must be constantly acquired. In commercial lending the borrowers are expected to repeat their borrowings at periodic intervals and such a practice is not an evidence of financial weakness; but in personal loans the funds advanced are for emergencies; *repeat* business is discouraged, and the borrowers are expected to improve their financial condition to make further borrowing of that character unnecessary. If the same borrower returns over and over again, it is an indication of shiftlessness or bad management and he becomes a progressively poorer risk. More effort to obtain new business is therefore required than in the case of commercial customers, otherwise the department business will dry up.

The Savings Department.—For many years, the collection and care of time deposits were regarded as being outside the province of a so-called commercial bank. Cooperative or mutual (non-stock) societies called *Savings Fund* societies, privately owned savings banks, corporate savings organizations, and Building and Loan societies were all regarded as the proper agencies to which those with savings could go in order to earn a higher rate of interest on their deposits than could be secured by depositing in checking accounts. This was, of course, before the present tendency towards what has been termed *department store banking* had made its appearance. Today most commercial banks welcome savings accounts, and large urban institutions, in many instances, operate a fully staffed Savings Department.

One of the influences that has induced the development by banks of

savings departments is the low legal-reserve requirement against time deposits, and for banks in the Federal Reserve System this is particularly important, as no interest is paid on the reserve accounts. In consequence, some banks encourage the deposit of funds in savings accounts, even at the higher rate paid on savings deposits, and allow considerable latitude in the matter of withdrawals without notice.

The savings bank and the savings department of a commercial bank arose, however, out of a need for a place in which those saving in small amounts, usually $100 or under, could deposit their funds with a maximum of security and at the same time receive a substantial return in the form of interest. The laws of most of the states require that a depositor in a savings bank give notice of 10 to 90 days before withdrawals can be made from the deposits. However, in practice, savings departments will often allow depositors to withdraw part or the whole of their deposit immediately, although in most cases some reduction will be made in the amount of interest paid to the depositor, if a substantial part of the deposit is suddenly withdrawn. Some institutions will require, in practice, 1 week's notice, if the depositor desires to receive the full interest which has accumulated in his account. The advent of commercial banks in the savings business has, of course, increased competition and has led to a relaxation of the requirements concerning withdrawals.

Due to the fact that savings deposits are generally long-term deposits, they may be invested in what might be termed *fixed-capital* investments rather than short-term loans. In practice, some commercial banks do not segregate their savings deposits other than in the books of the bank, and mingle the funds with funds from other sources. It will generally be found, however, that the bank's investments in so-called investment securities bear some fairly definite relation to the amount of savings deposits.

The savings department does not require a transfer division, or a credit division, or many of the other divisions required by a commercial banking department. It usually has a new accounts division, a division handling the deposits and the withdrawals, an investment division, and a bookkeeping division. The accounts carried by a savings department usually consist of individual accounts, joint accounts, trustee accounts, and society and club accounts, and the method of opening an account in a savings department does not vary to any extent from the opening of a checking account. However, the pass book given the depositor is of more importance than in the case of a checking-account pass book.

This pass book

> . . . serves (*a*) as a contract between customer and bank, (*b*) as a minature ledger of all deposits and withdrawals, and (*c*) as an instrument which is assignable. The pass book contains a statement of the regulations governing both depositor and bank. In general, the former is regarded as a creditor who has given a sum of money to the latter, which thus becomes the debtor. The bank promises to exercise due care in investing this fund, while the client, on his part, consents to follow certain rules relating to the making and withdrawing of deposits, and in all these transactions he agrees to present his pass book.[1]

The pass book contains the printed rules of the bank respecting the repayment of the deposits. Most states hold that the depositor, in accepting the pass book and making deposits, assents to these rules and is bound by them; but in at least two jurisdictions (Michigan and California) it has been held that the depositor is not bound by the printed rules unless they are called to his attention and he then assents to them.

Withdrawals.—It is generally a rule printed in the passbook, that the pass book is the sole evidence of the right to withdraw and that a payment to a person presenting the book shall be effectual to discharge the bank: but it has been decided that this does not relieve the bank of the duty to exercise care in allowing withdrawals, and the bank may be held liable for making payments to a wrongful holder of the pass book, if there are any circumstances which should warn the bank of irregularity.

A bank may permit withdrawals without the pass book, and the bank cannot be held liable for permitting a depositor to withdraw his account after the assignment of his pass book to another, in the absence of actual or constructive notice by the bank of the assignment. Pass books are assignable, but they are not negotiable instruments, and assignees thereof have no rights against the bank superior to those of the assignor. Thus the assignee cannot hold the bank liable for withdrawals made prior to the assignment, but not entered in the pass book. It follows that pass books should never be purchased in reliance upon the amounts shown therein without inquiry at the bank.

If a pass book is lost, the bank should be immediately notified. Upon receiving an affidavit of the loss, the bank will issue a duplicate pass book, and may require the depositor to furnish an indemnity bond to protect the bank from loss, if it should be compelled to make pay-

[1] Willis, H. Parker, and George W. Edwards, "Banking and Business," p. 313, Harper & Brothers, New York, 1925.

ment on the lost book. However, no claim could be made by the bank if it made payment on the lost book to any one not entitled thereto, after it had received notice of the loss.

Forgery.—Banks are not liable in paying out savings accounts on forged orders to the same extent as they are in honoring forged checks. Savings accounts are generally withdrawn infrequently, and banks do not have the same opportunity to familiarize themselves with the signatures of savings depositors. They are therefore only liable for negligence in making such payments. They have been held liable where the circumstances were such as to put them on notice of irregularity, as, for example, where the signature of the depositor on the check or order differed materially from the signature on the signature card. The requirement of due care on the part of the bank exists even when the pass book recites a rule that payment to a person presenting the pass book discharges the bank.

Inte. est.—Interest on savings deposits is paid at a higher rate than on checking accounts. The prevailing rate today is 4 per cent. There is no entirely uniform method of calculating the interest to be allowed. Interest may be calculated only on sums in multiples of $5, and generally it is not paid on the average balance, but only on the lowest amount remaining to the credit of a customer within a limit of time, so that withdrawals before that time would result in a loss of interest. Interest is usually computed twice yearly, generally the first of January and the first of July, and then added to the principal of the deposit.

Safe Deposit and Storage.—Practically all states have passed laws authorizing banks to receive special deposits for safekeeping and to lease safe-deposit boxes or own stock in a safe-deposit company to be run in connection with the bank's business. If the laws so permit, there is an advantage in organizing a separate corporation to carry on this business. Although a bank is not an insurer of the contents of safe-deposit boxes, it is liable for reasonable care in safeguarding the deposits, and a jury must decide what constitutes reasonable care in any particular case. A separate company may be organized with a capital very much smaller than the capital of the bank, and in the event of a large loss, the liability would be limited to the assets and perhaps double liability of the stock (where the state laws so decreed) of the safe-deposit company and not involve the bank beyond this figure.

Most banks furnish safe-deposit facilities and the larger institutions have elaborately equipped vaults with the latest modern improvements for the elimination of risk of fire and theft. The vaults contain boxes of different sizes which are rented to customers for an annual

rent that varies with the size of the box. The customers are furnished with keys and in the more recently constructed vaults the boxes can be opened only by the use of two keys, one in the possession of the bank's representative. To obtain access to the vault the customer must identify himself and sign a book or card giving his name, and the date and time of visit to the box, and the box number.

Attachment.—It is the law in most jurisdictions that the contents of the box are subject to attachment or execution by a creditor of the lessee, and that a sheriff under proper order may obtain possession thereof. In some jurisdictions the bank may be garnisheed. If garnishment proceedings are regularly taken against the bank, it is the duty of the bank to retain exclusive control of the box and its contents, denying access thereto by the lessee, until properly discharged by the court. Access to the box, however, can be obtained only by proper legal process, and it is the duty of the bank to prevent access to the box on the part of unauthorized individuals. For example, a revenue agent, acting simply under a general right to examine into the papers and accounts of the lessee, has no right of access without a court order.

Access.—Except under proper court proceedings, the lessee or lessees of a box have the sole right of access to it. They may in writing authorize the bank to permit the access of some designated person, but the bank should refuse access to any person failing to produce proper authorization from the lessee. So a wife has no right of access to the box during the husband's lifetime and without authorization from him. In the event of the death of the lessee, the bank should permit the nearest heirs to have access to the box in the presence of one of the officials of the bank to look for a will and make a list of the contents of the box. The will may be taken from the box for purposes of probate, but nothing else should be removed until the bank is furnished with proof of the appointment of an executor or administrator who thereafter has the right to withdraw the contents.

In renting a box, the lessee signs a contract expressing the terms and conditions of the lease, the right of access, and sometimes limiting the liability of the bank to the exercise of reasonable care. If keys are lost, this generally involves changing the lock, and the expense is borne by the lessee. The contract generally gives to the bank a lien on the contents of the box for unpaid rent.

Insurance.—Banks may and should carry insurance policies to cover their liability in the event of loss through theft or damage by fire or in other ways. While it is probable that the taking out of such insurance would not operate as an admission on the part of the bank

of liability in excess of the coverage, still, the bank should safeguard itself by incorporating in its rental agreement a clause stating that its insurance for the benefit of the lessees shall not be deemed to create any liability on the part of the bank to insure the contents of the boxes for their full value, which is unknown; and that, in the event of loss covered by the policy, the proceeds of the insurance shall first be applied to reimburse the bank for any loss it may have sustained in injury to the vault and boxes, and the balance shall be distributed pro rata among the lessees suffering loss.

Other Valuables.—In addition to safe-deposit boxes, some banks rent space for the storage of other more bulky valuables, chiefly silverware. If they charge for this service, their liability is that of an ordinary bailee for hire.

CHAPTER XXIII

FOREIGN DEPARTMENT

PRINCIPLES OF FOREIGN EXCHANGE

There was a lamentable lack of interest in foreign exchange in the United States prior to the World War. The mercantile marine of this country was insignificant, most of the foreign trade was handled by foreign steamship lines, its banking systems were antiquated, and the United States did not possess the banking machinery necessary for the financing of foreign trade. There was no central bank to which the other banks might have access and which is neçessary to the development of an international center of finance. The state and Federal banking laws did not authorize the use of the bank acceptance—an instrument necessary for financing foreign trade—while the trade acceptance was not utilized to any extent by the bankers of this country, and was looked down upon as an instrument for financing dubious trade transactions.

Changes Brought about by the World War.—The establishment of the Federal Reserve System provided central banking facilities, and the demands made upon the bankers of this country to finance the Allies created a spirit of internationalism which did not exist prior to the World War.

New York bankers were looking forward to the time when New York would be in a position to supplant definitely the English money market as the outstanding money market of the world. Not only were foreign exchange departments created as part of the bank's organization, but, in addition, national and state laws were modified in order to permit the opening up of foreign branches by the banks of this country.

This created an interest in foreign exchange, and it became a widely studied subject in banking circles.

Principles of Foreign Exchange Similar to Those of Domestic Exchange.—While foreign exchange appears to be a very complicated subject, yet, as a matter of fact, its principles generally are similar to the principles underlying the domestic exchange of a country, except

imports, and at the same time not to have a number of invisible imports to offset the excess exportation of merchandise, will eventually result in an influx of gold into this country at the expense of the foreign nations. This might not only handicap the monetary and banking systems of such nations and disrupt the export trade of this country, but in addition would probably encourage credit and currency inflation here.

Classification of Exports and Imports.—It is important to keep in mind that *favorable* or *unfavorable* balances relate only to the so-called visible items on the balance sheet. All imports and exports in international trade can be classified under the following heads: (1) visible items, sometimes referred to as *tangible items*, which consist of (*a*) merchandise, and (*b*) gold; and (2) invisible items, sometimes called *intangible items*, and which consist of (*a*) securities, and (*b*) services. The services might take the form of passenger or freight transportation via ocean shipping lines, or those services rendered by financial and insurance companies, accommodations and other services offered by hotel and restaurant keepers, and remittances sent by immigrants to families abroad.

The following table indicates the items affecting the international balance sheet of the United States:

IMPORTS	EXPORTS
(Giving rise to demand for bills of exchange in this market)	(Giving rise to supply of bills of exchange in this market)
Tangible or Visible Items:	Tangible or Visible Items:
1. Merchandise imports	1. Merchandise exports
2. Precious metals imports	2. Precious metals exports
Intangible or Invisible Items:	Intangible or Invisible Items:
3. Stocks and bonds, bought or redeemed	3. Stocks and bonds, sold
4. Interest and dividends, paid	4. Interest and dividends, received
5. Finance bills, paid	5. Finance bills, sold
6. Freight—American goods carried in foreign bottoms	6. Freight—foreign goods carried in American bottoms
7. Bankers' and brokers' commissions	7. Bankers' and brokers' commissions
8. Marine insurance—American ships and cargoes insured with foreign companies	8. Marine insurance—foreign ships and cargoes insured with American companies
9. Life insurance	9. Life insurance
10. Tourist expenditures	10. Tourist expenditures
11. Remittances to friends and relatives	11. Remittances from friends and relatives

The *items* appearing in the above balance sheet may be briefly described as follows:

Imports.—1. *Merchandise imports* refers to the importation of commodities by Americans purchased from foreigners. Thus, when an American importer buys gowns in Paris priced at 100,000 francs, it becomes necessary for the importer to pay for this purchase by either instructing the exporter in Paris to draw a bill on him, or by purchasing in the New York market French exchange in sufficient amount to pay off the account. In either case, the effect upon exchange rates will be the same, but in the first case the supply of bills in Paris will be increased, in the second case the demand for bills in New York will be augmented.

2. *Precious Metal Imports.*—Gold is the metal most generally used in international trade, primarily because of the fact that gold is used as the basis for most of the monetary systems of the world. It has become common practice to use gold as the medium for settling balances between nations which remain after the balancing of the merchandise imports and exports together with the invisible imports and exports. A situation has developed during and since the World War which has led to the concentration of a large part of the world's supply of gold in the United States, and which many times has made it impossible to balance the payments between Europe and this country by shipments of gold.

The situation arising from the unusual distribution of the gold supply of the world is covered in more detail at a later point.

3. *Stocks and Bonds. Bought or Redeemed.*—The importation in so far as this item is concerned consists of European securities purchased by Americans, or of American securities which have been owned by Europeans, repurchased by Americans, or American securities held abroad and which have matured and have been presented to the issuring corporations for redemption.

4. *Interest and dividends, paid,* represents debts due foreign holders of American securities and which must be paid. The effect is therefore the same as the importation of goods. In a sense, it may be said that there is here an importation of coupons or of receipts used as evidence of the payment of interest and dividends.

5. *Finance bills, paid,* represents debts due by American banks or bankers as a result of drafts drawn on them by foreign bankers. These must be paid and it may be said that there is here an importation of the finance bill itself.

6. *Freight—American goods carried on foreign vessels* has the effect of an importation into this country, because the services rendered by the foreign steamship companies which carry American goods must be paid for by the Americans, and therefore the effect on international

exchange is similar to that caused by an importation of actual goods. The importation here consists, it might be said, of the services rendered by the foreign steamship companies.

7. *Bankers and brokers' commissions* represents those sums paid to foreign bankers and brokers for services rendered.

8. *Marine insurance—American ships and cargoes insured with foreign companies* is treated as an import because the services rendered by the foreign insurance companies must be paid for by the Americans, and such payments give rise to a demand for bills of exchange.

9. *Life insurance—American citizens insured with foreign companies* is listed as an import because it represents services rendered by European companies which must be paid for by the insured. This item was of considerable importance prior to the World War because of the strength of many of the English and German life insurance companies. However, due to the economic effects of the war in so far as Europe is concerned, and the rapid growth of American companies, this item has diminished somewhat in importance.

10. *Tourist expenditures* represents an import because of the services rendered by foreigners in the form of transportation abroad, hotel accommodations and the many other expenses which are incurred by Americans traveling abroad, all of which must be paid for by the Americans and the effect of which is to give rise to bills of exchange, just the same as if merchandise had been actually imported into this country.

11. *Remittance to friends and relatives abroad* represents the sums which are sent chiefly by those immigrants who have settled in this country and who send back annually large sums to members of their families who have not yet migrated to this country.

Exports.—1. *Merchandise exports* represent the commodities which are sold to foreigners, and which give rise to a supply of bills of exchange or drafts drawn by the American exporters on their foreign debtors or debtors' banks.

2. *Precious metal exports* is just the opposite of the item *Precious metal imports*, and needs no further explanation.

3. *Stocks and bonds, sold,* represents an exportation of the actual securities sold and which must be paid for by the purchasers living abroad.

4. *Interest and dividends, received,* represents the receipt of interest and dividends due American holders of foreign securities.

5. *Finance bills, sold,* represents debts due American bankers and, in a sense, the exportation of the finance bills.

6. *Freight—foreign goods carried in American bottoms* is an export because the services are rendered by American shipowners to European shippers, and must be paid for by the latter.

7. *Bankers' and brokers' commissions* represents commissions received by American bankers and brokers from foreigners in the course of their business operations.

8. *Marine insurance—foreign ships and cargoes insured with American companies* is an export because the services are rendered by American insurance companies and must be paid for by the European beneficiaries.

9. *Life insurance* represents the services rendered by American companies to European policyholders.

10. *Tourist expenditures* refers to the services rendered by American citizens in meeting the demands of European travelers in this country.

11. *Remittances from friends and relatives* represents sums sent from foreigners to those residing in this country.

Rates of Exchange.—It has often been stated that the rate of exchange in a market is determined by the supply of and the demand for bills of exchange. Thus, at any given time, the price in New York of drafts on London, that is to say, the rate of exchange on London, is fixed at a point where the supply of and the demand for exchange bills meet. In turn, as shown in the above balance sheet, the supply of and the demand for bills of exchange depend upon the purchases and sales of merchandise, securities, and services.

Whitaker [1] designates the three principal methods utilized for quoting exchange rates as follows:

1. The premium-and-discount method
2. The direct-price method
3. The indirect-price method.

The premium-and-discount method is sometimes used in quoting exchange between countries having a like monetary unit. Thus, for example, the Canadian dollar was quoted in New York on Aug. 1, 1929, at a discount of $\frac{15}{64}$ to $\frac{5}{16}$. It therefore cost approximately $0.997 to buy a Canadian dollar in New York. However, at the present it is more customary, even in the case of two countries using a like standard, to quote exchange by the direct-price method. The direct-price method quotes the foreign currency in terms of the money of the home country. This method is most frequently used in this country at the

[1] WHITAKER, ALBERT C., "Foreign Exchange," p. 73, D. Appleton & Co., New York, 1919.

present time. The Federal Reserve System, for example, publishes daily a certified list of foreign exchange rates, all quoted by the direct method. The list, certified as of Aug. 1, 1929, appears herewith.

FOREIGN EXCHANGE RATES CERTIFIED BY FEDERAL RESERVE BANKS TO TREASURY UNDER TARIFF ACTS OF 1922 [1]

Noon Buying Rate for Cable Transfers in New York, Aug. 1, 1929
(Value in United States Money)

Country and monetary unit	Value, dollars	Country and monetary unit	Value, dollars
Europe:		Asia:	
Austria, schilling	0.140617	China:	
Belgium, belga	0.139051	Chefoo, tael	0.599583
Bulgaria, lev	0.007220	Hankow, tael	0.591562
Czechoslovakia, krone	0.029592	Shanghai, tael	0.576607
Denmark, krone	0.266438	Tientsin, tael	0.609583
England, pound sterling	4.851896	Hong Kong, dollar	0.481071
Finland, markka	0.025152	Mexican dollar	0.416250
France, franc	0.039187	Tientsin or Pelyang dollar	0.418333
Germany, reichsmark	0.238296	Yuan dollar	0.415000
Greece, drachma	0.012922	India, rupee	0.359787
Holland, guilder	0.400793	Japan, yen	0.466359
Hungary, pengö	0.174333	Singapore (S.S.) dollar	0.558916
Italy, lira	0.052293	North America:	
Norway, krone	0.266538	Canada, dollar	0.997407
Poland, zloty	0.111872	Cuba, peso	0.999237
Portugal, escudo	0.044575	Mexico, peso	0.484075
Rumania, leu	0.005933	Newfoundland, dollar	0.994667
Spain, peseta	0.146128	South America:	
Sweden, krona	0.268027	Argentina, peso (gold)	0.954342
Switzerland, franc	0.192416	Brazil, milreis	0.118609
Yugoslavia, dinar	0.017558	Chile, peso	0.120709
		Uruguay, peso	0.988550
		Colombia, peso	0.963900

[1] *Commercial and Financial Chronicle*, Vol. 129, No. 1, p. 693, Aug. 3, 1929.

The indirect method refers to the quotation of the number of units of foreign currency which can be bought with one unit of home currency. Thus, if a franc is quoted by the direct methods at $0.039, that is to say, a franc is worth approximately 4 cents in American money, to quote it by the indirect method it would be stated that exchange was at 25.64. One dollar (United States) will buy 25.64 francs.

Escher, in his concise and admirable volume, "Elements of Foreign Exchange," enumerates the influences tending to raise and lower exchange rates, using New York as the operative point. The factors operating to raise exchange rates are as follows:

1. Large imports, calling for large amounts of exchange with which to make the necessary payments.
2. Large purchases of foreign securities by us, or repurchase of our own securities abroad, calling for large amounts of exchange with which to make payments.
3. Coming to maturity of issues of American bonds held abroad.
4. Low money rates here, which result in a demand for exchange with which to send banking capital out of the country.
5. High money rates at some foreign center, which create a great demand for exchange drawn on that center.

A factor of comparatively recent appearance which should be added to the above list of Escher's is large loans and credit advances to foreign governments, banks, and business corporations.

The factors operating to lower exchange rates are:

1. Especially heavy exports of merchandise.
2. Large purchases of our stocks by the foreigners and the placing abroad of American bonds.
3. Distrust on our part of financial conditions existing at some point abroad where there are carried large deposits of American capital.
4. High money rates here.
5. Unprofitably low loaning rates at some important foreign center where American bankers ordinarily carry large balances on deposit.[1]

Mint Par of Exchange.—The mint parity of exchange theory is usually advanced to explain tendencies in exchange fluctuations.

Discussing it briefly, the mint par of exchange might be stated as that rate at which the standard coin of one country is convertible into that of another country, and, therefore, it is determined by the relative weight and fineness of the precious metal contained in the standard coins. This theory only applies to countries which are on the same metallic standard. There can be no mint par between a country on a gold standard and one on a silver standard, because of the absence of a fixed ratio between gold and silver; and there can be no mint par between a country on a gold basis and one on a paper basis, or between two countries, each on a paper basis, because no fixed ratio exists between such standards.

Using as an illustration the currency of two countries which are on the gold standard, one might take the relation of the pound sterling

[1] ESCHER, FRANKLIN, "Elements of Foreign Exchange," 9th Ed., Bankers' Publishing Company, New York, 1920.

and the gold dollar. The pound sterling contains 113.0015 grains of pure gold, while the dollar contains 23.22 grains of pure gold. Comparing these two monies, it is obvious that the pound contains more gold than does the dollar, and, by dividing the gold content of the dollar into the gold content of the pound, the figure 4.8665 is reached. That figure represents the mint par of exchange between the pound and the dollar; in other words, the pound sterling is worth \$4.86+ in American money. A like method is used to find the mint parity of exchange between the dollar and the currencies of other foreign countries on a gold standard. The mint pars of exchange between the United States dollar and the currency of some of the more important foreign countries on a gold standard are as shown on pp. 303 and 304.

The mint parity of exchange theory states that exchange rates will tend to be expressed at the point where the intrinsic values of the currencies of the several countries coincide. Any fluctuation around the coincidental point will be limited by the actual shipment of the gold metal. The extreme limits of fluctuation are labeled the gold points and, using once more the pound in its relation to the dollar as an illustration, the gold points between these two currencies may be expressed at \$4.8465 and \$4.8865.[1] In other words, under this theory of exchange, the fluctuations will be limited between these two points, and if the exchange rates tend above or below those points, a shipment of gold will result which ordinarily will restore the exchange rates to within these points. The difference, in the illustration, between the mint par of exchange and the gold points, namely 2 cents, represents the costs of preparing for shipment, shipping, insuring, and assaying bullion worth \$4.8665, together with the interest lost on the sum in shipment. Should the exchange rates rise above \$4.8865, therefore, gold would be shipped from the United States to England, and this automatically would cause the exchange rates to fall to \$4.8865 or less, because no bills would be purchased in the market above \$4.8865, when one could go and purchase gold and ship it to England at an expense which would place the total cost of the transaction at approximately \$4.8865 per pound sterling. If the rate would fall below \$4.8465, gold would be shipped from Great Britain to the United States, and this in itself would tend to raise the rate towards the mint par of exchange. Summing up this theory, it can be stated that the rate of exchange will go above or below mint par only by the sum of the several expenses involved in the transporta-

[1] The above gold points are used as illustrative of how gold points are arrived at. The actual gold points between sterling and the dollar vary, depending upon the fluctuating costs of the several factors involved in the shipment of gold.

VALUES OF FOREIGN COINS

1914
Department Circular No. 1
Director of the Mint

TREASURY DEPARTMENT,
OFFICE OF THE SECRETARY.
Washington, D. C., January 1, 1928.

In pursuance of the provisions of Section 25, of the Act of August 27, 1894, as amended by Section 403, Title IV, of the Act of May 27, 1921, and reenacted by Section 522, Title IV, Act of September 21, 1922, I hereby proclaim the following estimate by the Director of the Mint of the values of pure metal contents of foreign coins to be the values of such coins in terms of the money of account of the United States, to be followed in estimating the value of all foreign merchandise exported to the United States during the quarter beginning January 1, 1928, expressed in any such metallic currencies: *Provided, however,* That if no such value has been proclaimed, or if the value so proclaimed varies by five per centum or more from a value measured by the buying rate in the New York market at noon on the day of exportation, conversion shall be made at a value measured by such buying rate, as determined by the Federal Reserve Bank of New York and published by me as certified by said bank pursuant to the provisions of said Section 25 as amended.

ANDREW W. MELLON, *Secretary of the Treasury.*

Country	Legal standard	Monetary unit	Value in terms of United States money	Remarks
Argentine Republic	Gold	Peso	$0.9648	Currency: Paper normally convertible at 44 per cent of face value.
Austria	Gold	Schilling	0.1407	
Belgium	Gold	Belga	0.1390	1 belga equals 5 paper francs.
Bolivia	Gold	Boliviano	0.3893	12½ bolivianos equal 1 pound sterling.
Brazil	Gold	Milreis	0.5462	Currency: Government paper a part of which is legally convertible at 16 pence (=$0.3244) per milreis; now inconvertible.
British Colonies in Australasia and Africa	Gold	Pound Sterling	4.8665	
British Honduras	Gold	Dollar	1.0000	
Bulgaria	Gold	Lev	0.1930	
Canada	Gold	Dollar	1.0000	
Chile	Gold	Peso	0.1217	
Colombia	Gold	Peso	0.9733	Currency: Government paper and silver.
Costa Rica	Gold	Colon	0.4653	Law establishing conversion office fixes ratio 4 colons (non-gold) = $1 U. S.
Cuba	Gold	Peso	1.0000	
Denmark	Gold	Krone	0.2680	
Dominican Republic	Gold	Dollar	1 0000	United States money is principal circulating medium.
Ecuador	Gold	Sucre	0.2000	By law effec. Mar. 19, 1927.
Egypt	Gold	Pound (100 piasters)	4.9431	The actual standard is the British pound sterling, which is legal tender for 97½ piasters.
Esthonia	Gold	Kroon	0.2680	
Finland	Gold	Markka	0.0252	
France	Gold and silver	Franc	0.1930	
Germany	Gold	Reichsmark	0.2382	
Great Britain	Gold	Pound Sterling	4.8665	
Greece	Gold and silver	Drachma	0.1930	
Guatemala	Gold	Quetzal	1.0000	
Haiti	Gold	Gourde	0.2000	Currency: National bank notes redeemable on demand in American dollars.
Honduras	Gold	Lempira	0.5000	Legally established but not yet actually operative.
Hungary	Gold	Pengö	0.1749	
India [British]	Gold	Rupee	0.3650	By law effective Apr. 1, 1927.
Italy	Gold	Lira	0.0526	By decree eff. Dec. 22, 1927.
Japan	Gold	Yen	0.4985	

VALUES OF FOREIGN COINS—*Continued*

Country	Legal standard	Monetary unit	Value in terms of United States money	Remarks
Latvia	Gold	Lat	0.1930	
Liberia	Gold	Dollar	1.0000	Currency: Depreciated silver token coins.
Lithuania	Gold	Litas	0.1000	Currency: Notes of the bank of Lithuania.
Mexico	Gold	Peso	0.4985	
Netherlands	Gold	Guilder (florin)	0.4020	
Newfoundland	Gold	Dollar	1.0000	
Nicaragua	Gold	Cordoba	1.0000	
Norway	Gold	Krone	0.2680	
Panama	Gold	Balboa	1.0000	
Paraguay	Gold	Peso (Argentine)	0.9648	Currency: Depreciated Paraguayan paper currency.
Peru	Gold	Libra	4.8665	
Philippine Islands	Gold	Peso	0.5000	
Poland	Gold	Zloty	0.1122	By decree eff, Oct. 13, 1927.
Portugal	Gold	Escudo	1.0805	Currency: Inconvertible paper.
Rumania	Gold	Leu	0.1930	
Russia	Gold	Ruble	0.5146	Pre-war unit. (One Soviet chervonetz = 10 gold rubles.)
Salvador	Gold	Colon	0.5000	
Siam	Gold	Tical	0.3709	
Spain	Gold and silver	Peseta	0.1930	Valuation is for gold peseta; currency is notes of the bank of Spain.
Straits Settlements	Gold	Dollar	0.5678	
Sweden	Gold	Krona	0.2680	
Switzerland	Gold	Franc	0.1930	
Turkey	Gold	Piaster	0.0440	(100 piasters equal to the Turkish £.)
Uruguay	Gold	Peso	1.0342	Currency: Inconvertible paper.
Venezuela	Gold	Bolivar	0.1930	
Yugoslavia	Gold	Dinar	0.1930	

tion of the specie between the places involved. This theory is predicated upon the assumption that free gold movements exist, and that no artificial restraints are placed by government or semigovernment institutions upon the shipment of specie. There are times when banks, for reasons such as the desire to influence security market prices, or the money market, will refrain from shipping gold, even though it would be profitable to do so. During and immediately following the war, free gold movements did not exist in all cases, as the governments of the world had placed embargoes on the exportation of gold, and thus the exchanges could not be supported. Even at the present time, there is an artificial situation in the foreign-exchange market due to the outstanding financial position of the United States and the endeavor on the part of central banking authorities to stabilize European currencies. The following table indicates the foreign-exchange situation during the World War period, and up to 1928, and illustrates the absence of gold points.[1]

[1] The reader is referred to the books on foreign exchange, a list of which are suggested at the conclusion of this chapter, for a more extended discussion of the subject.

Exchange Rates of the Dollar in Terms of Currencies of Canada, Germany, Italy, France, England, Switzerland, Holland, Spain, Sweden, Argentina and Japan. 1914-Date. Dec. 31 in Each Case.

MOVEMENT OF EXCHANGE RATES (HIGHEST RATES FOR SIGHT DRAFTS DURING MONTH) IN NEW YORK ON PRINCIPAL FINANCIAL CENTERS, DECEMBER, 1914–1918 *

	1914		1915		1916		1917		1918	
	Dollars	Per Cent	Dollars	Per Cent	Dollars	Per Cent	Dollars	Per Cent	Dollars	Per Cent
Berlin	92.50	97.16	79.75	83.77	72.25	79.04	71.50 (March)	75.11	....	....
Milan 19.3 = 100	19.12	99.07	15.35	79.53	15.02	77.82	12.52	64.87	15.75	81.61
Paris 19.3 = 100	19.57	101.40	17.21	89.17	17.14	88.81	17.45	90.41	18.55	96.11
London 4.8665 = 100	4.8925	100.53	4.74125	97.43	4.7569	97.75	4.7525	97.66	4.7575	97.76
Zurich 19.3 = 100	19.29	99.95	19.08	98.86	20.28	105.08	23.42	121.35	20.32	105.28
Amsterdam 40.2 = 100	40.62	101.04	43.50	108.21	40.87	101.67	44.50	110.70	42.25	105.10
Madrid 19.3 = 100	....	....	18.90	97.93	21.25	110.10	24.40	126.42	20.7	107.25
Rio de Janeiro 32.444 = 100	....	....	23.62	72.81	23.63	72.84	26.90	82.91	27.0	83.22
Copenhagen 26.8 = 100	25.25	94.22	28.00	104.48	27.80	103.73	33.75	125.93	27.0	100.75
Yokohama 49.85 = 100	49.90 (July)	100.10	50.50	101.30	50.88	102.07	51.80	103.91	54.75	109.83

* Fed. Res. Bull., Vol. 4, pp. 837–839 and 1199, 1918.

EXCHANGE RATES OF THE DOLLAR IN TERMS OF CURRENCIES OF CANADA, GERMANY, ITALY, FRANCE, ENGLAND, SWITZERLAND, HOLLAND, SPAIN, SWEDEN, ARGENTINA AND JAPAN. 1914-DATE. DEC. 31 IN EACH CASE.

FOREIGN EXCHANGE RATES, 1919–1927 *

Yearly Averages.† In Cents per Unit of Foreign Currency

	1927 Par of Exchange	1919	1920	1921	1922	1923	1924	1925	1926	1927	1928
Germany......	23.82	3.0440	1.7510	1.2045	0.2323	0.0020	....	23.8031	23.7996	23.7638	Stabilizations and changes in gold content effected during 1928 make later figures incomparable with 1919–1927.
Italy..........	19.30	11.3690	4.9700	4.2936	4.7559	4.6016	4.3580	3.9776	3.8894	5.1560	
France.........	19.30	13.6820	7.0400	7.4554	8.2013	6.0811	5.2368	4.7671	3.2427	3.9240	
England.......	486.65	442.580	366.4270	384.906	442.917	457.483	441.7064	482.894	485.824	486.102	
Switzerland....	19.30	18.983	16.9030	17.3539	19.0652	18.0600	18.2228	19.3268	19.3130	19.2618	
Holland.......	40.20	39.1470	34.4190	33.6470	38.4975	39.1005	38.2109	40.1601	40.0984	40.1065	
Spain.........	19.30	19.8230	15.9380	13.5314	15.4828	14.4529	13.3375	14.3443	14.9959	17.0592	
Argentina.....	96.48	99.0180	90.7040	72.9999	81.8166	78.5727	78.1308	91.3822	92.1497	96.2950	
Sweden.......	26.80	25.5420	20.4940	22.5397	26.1661	26.5548	26.5223	26.8479	26.7646	26.8148	
Japan.........	49.85	51.1840	50.3680	48.2485	47.8037	48.5845	41.1857	41.0362	47.1163	47.4113	

* Fed. Res. Bull., Vol. 14, p. 56, 1928.

† Based on noon-buying rate for cable transfers in New York as certified to the Treasury by the Federal Reserve Bank of New York, in pursuance of the provisions of Sec. 522 of the Tariff Act of 1921.

Exchange Rates between Gold and Silver Countries.—Practically all of the monetary systems of the world, today, are based upon gold. China, which in the past has been cited as an example of a country on a silver standard, is at the present time renovating its banking system and it appears as if that country would soon go on a gold basis. However, for the purpose of illustration of the fixation of exchange rates between a country on a gold standard and a country on a silver standard, China might be cited as an example.

The price of gold in the United States is fixed by law, while the price of silver in China is subject to the fluctuations in the value of silver as determined in the silver markets of the world, of which the London market is the most important. In that market, the price of silver is expressed in terms of gold, as the English pound sterling is a gold coin. The value of the currency of a country on a silver standard, therefore, varies, when expressed in terms of the currency of a country on a gold standard, with the changing price of the commodity, silver. A decline in the gold price of commodity silver will be followed by a decline in the exchange rate of China (the country on the silver standard) in the New York market (the country on the gold standard). Of course, the fluctuations of the exchange rates within the limits set by the price of commodity silver are determined by the supply and the demand for bills of exchange.

Foreign Exchange Operations.—Escher lists as the more important forms of activity in the foreign exchange market the following: [1]

1. Selling demand against demand
2. Selling cables against demand exchange
3. Selling demand bills against remittances of long bills
4. The operation of making foreign loans in the American market
5. The drawing of finance bills
6. Arbitrating in exchange.

The advent of this country into the ranks of the creditor nations has opened up an additional operation, namely, the extension of credit to foreign borrowers. The amount of capital loaned by American bankers to foreign governments and enterprises from 1914 to 1918 is disclosed in the following table.

[1] Escher, Franklin, "Elements of Foreign Exchange," Chap. VI.

TOTAL FOREIGN SECURITIES PUBLICLY OFFERED IN THE UNITED STATES, 1914–1928 *

Year	Number of issues	Nominal capital	Estimated refunding to Americans	Estimated net nominal capital
1914	19	$37,722,750	. . . .	$37,722,750
1915	87	833,494,614	$19,500,000	813,994,614
1916	104	1,131,080,264	7,750,000	1,123,330,264
1917	67	718,147,450	32,000,000	686,147,450
1918	30	29,715,000	1,600,000	28,115,000
1919	81	813,244,700	250,920,300	562,324,400
1920	105	636,191,357	151,000,000	485,191,357
1921	109	675,112,963	44,105,083	631,007,880
1922	136	828,399,284	146,121,300	682,277,984
1923	73	495,662,100	82,000,000	413,662,100
1924	129	1,219,541,687	291,047,945	928,493,742
1925	156	1,329,920,750	244,540,000	1,085,380,750
1926	214	1,318,554,850	183,895,200	1,134,659,650
1927	253	1,592,595,760	216,882,700	1,375,713,060
1928	220	1,487,861,680	236,910,413	1,250,951,267

* "The Balance of International Payments of the United States in 1928," p. 39, Bureau of Foreign and Domestic Commerce, U. S. Department of Commerce.

In addition, there were a number of direct advances made by American bankers to foreign enterprises. It may thus be seen that the function of supplying capital to foreign borrowers is an important one in American banking circles.

It is not within the scope of this book to discuss in detail these various operations in the foreign exchange market. For a more detailed discussion of this subject, the interested reader is referred to any one of the several texts listed at the end of this chapter.

Influence of the Flow of Gold.—The effect of the World War upon the distribution of gold among the countries of the world has tended to make gold movements even more complicated. Prior to the World War, gold was shipped between countries when and if the gold points were reached. During and for a short time after the World War, exchange rates were pegged and shipments of gold were practically eliminated. Embargoes were placed upon the exportation of gold by all of the belligerent nations and many of the neutral powers. When these embargoes were removed, gold movements took place which finally resulted in the United States' securing a substantial part of the gold supply of the world. The following table indicates the increase in the supply of gold held by this country from 1913 to 1929.

Gold Coin and Bullion in the Vaults of the U. S. Treasury Department and the Federal Reserve System, 1913–1927 *

As of June 30. In Thousands of Dollars

1913	1,870,762	1922	3,784,652
1914	1,890,657	1923	4,049,554
1915	1,985,539	1924	4,488,391
1916	2,444,668	1925	4,364,632
1917	3,218,067	1926	4,447,397
1918	3,162,793	1927	4,587,298
1919	3,113,306	1928	4,109,000
1920	2,865,482	1929	4,325,000
1921	3,274,730		

* Statistical Abstract of the United States, 1928, p. 238; Fed. Res. Bull., Vol. 15, p. 446, July, 1929.

This country secured more gold than was necessary for its banking and monetary reserves, while the principal countries of Europe did not have sufficient gold to stabilize their banking systems, with the result that the United States was constantly being approached to extend more and more credit, often in the form of gold shipments to the European powers.

Various devices were resorted to in order to influence the flow of gold from the United States to Europe, and to discourage its exportation to this country. In the chapter on Federal Reserve discount policies, the activities of the Federal Reserve System in attempting to control the flow of gold are discussed in some detail. It should be stated that gold movements are not entirely natural, even at this time. There is a tendency among the central banks to cooperate in controlling the flow of gold artificially. The *earmarking* [1] of gold has also reduced actual shipments of the metal.

The following quotation, from the *Wall Street Journal* of Aug. 10, 1929, is of interest:

> Rates in the foreign exchange market were lower following the 6 per cent bank rate announcement of the New York Federal Reserve Bank, but there were no spectacular breaks, and business was generally restricted. This was chiefly due to fears that had been expressed in some quarters that the Bank of England would be forced to take immediate steps to raise its rediscount rate. Sterling, however, tended to move lower, ruling at $4.84\frac{3}{4}$ to $\frac{13}{16}$. The quotation

[1] *Earmarked* gold refers to the setting aside of gold in a bank and crediting it to a second institution even though the actual shipment is not made. For example, the Bank of France may have the Federal Reserve Bank of New York set aside $50,000,000 worth of gold, although they do not expect to call the gold from the New York bank. This, of course, removes it from the reserves of the New York bank.

of $\frac{3}{4}$ equals the low for the year touched just before the rise in the bank rate to $5\frac{1}{2}$ per cent in February. . . .

The foreign exchange market is likely to remain conservative in its commitments until there are more definite indications of the course of action to be adopted by the Bank of England in regard to its rediscount rate. It is generally understood that Governor Montagu Norman gave representatives of the London discount market personal assurances that no change in the English rate was to be expected Thursday, and it is reported, though not confirmed, that he declared no change was contemplated this month.

Against this statement, however, traders are inclined to balance the fact that sterling is now at a point at which gold shipments can be made with good profits from London to New York. A gold flow seems inevitable to this center, unless some agreement exists between the London authorities and New York Federal Reserve and banking houses. . . .

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CHAPTER XXIV

FOREIGN DEPARTMENT (*Continued*)

THE OPERATIONS OF THE FOREIGN DEPARTMENT

While a great many types of documents are used in connection with the work of the foreign department of a modern bank, it does not come within the province of this chapter to discuss other than the more important types of bills bought and sold in the New York market. Probably the most important bill used in foreign exchange is the commercial long bill.

Commercial Long Bill.—These bills arise out of commercial transactions involving the purchase of merchandise. The bills are drawn upon the buyer of the merchandise or upon the banker designated by the buyer of the merchandise and acting as his agent in the transaction. The bills are drawn at 30 days' sight or longer, depending upon the circumstances involved in each transaction. These bills may be of two types, either *clean bills*, that is to say, bills unaccompanied by any shipping documents or other documents giving title to the goods involved in the transaction, or bills accompanied by the several shipping documents, together with insurance policies, etc. The latter type of bill will be discussed first.

A sale of cotton might be financed by a 90-day sight bill drawn on the English importer of the cotton by the exporter in New Orleans. This bill would be drawn in pounds sterling, and might be payable by the importer 90 days after the importer had written *accepted* over the face of the bill. The bill, accompanied by the bill of lading, giving title to the cotton, together with the insurance policy, will be a *commercial long bill with documents attached.* Very often other documents of minor importance accompany the commercial long bill, such as the commercial invoice, certified invoice, consular invoice, certification of origin, weight note, weight certificate, inspection certificate, quality certificate, analysis certificate, etc., depending upon the nature of the shipment and its destination.

More frequently, probably, such a transaction would be financed by the medium of the English bank used by the importer of the cotton.

The English importer of the cotton acquires a letter of credit from the bank, which indicates the fact that the bank will accept a bill drawn on it up to a stated amount. In that case, the American exporter of the cotton would draw on the English bank from which the letter of credit originated instead of drawing on the English importer of the cotton. The bill of lading and the insurance policy would accompany this draft drawn on the bank. It is profitable in most cases to utilize a bank as a medium for financing such transactions because of the superior rating accruing to the bill drawn on a bank, as contrasted to a bill drawn on an individual.

If the American exporter of cotton desires to get immediate funds, he can take the bill which has been drawn on the importer of cotton or on the latter's bank, together with the documents attached thereto, and discount it at his own bank in New Orleans. Thus, the American exporter has his funds and the New Orleans bank is in possession of the commercial long bill with documents attached, which it sends over to the drawee in England, so that the latter might accept it and thereby might gain possession of the cotton, the ownership of which is represented in the bill of lading attached to the commercial long bill.

Documentary commercial long bills are of two types—first, *acceptance bills*, and, second, *payment bills.* In the case of an acceptance bill, the shipping documents are delivered to the drawee upon the acceptance of the bill by the latter, and, therefore, he is in a position to get immediate possession of the goods. A payment bill is used in a case where the credit of the drawee is not quite so good, and therefore he must make payment to the holder of the bill under a rebate of interest arrangement before he can get possession of the shipping documents entitling him to possession of the goods. In some cases payment bills are allowed to run to maturity before payment is made and goods delivered to the importer. This would be possible in the case of a shipment of cotton. Obviously, in the case of perishable goods, it would not be possible to let the payment run for too long a period of time, and therefore payment documents financing the shipment of perishable goods usually command a better rate than do these accompanying non-perishable commodities.

In many cases, the relationship between American exporters of goods and foreign importers has been of many years' standing, and therefore no question arises as to the financial responsibility of the purchaser of the goods. In such cases it frequently happens that *clean bills* are utilized in financing transactions; goods are exported to foreign importers and the exporter refrains from drawing on the

importer until some time after the goods have been actually exported. No shipping documents are present at the time when the bill is drawn on the importer of the goods and, therefore, the commercial bill goes forward without having any documents attached to it. Clean bills, in order to have a standing satisfactory to the banks, must be drawn by houses with the best of reputations, as there is no collateral present with such bills, and their worth is dependent upon the integrity of the drawers of the bills and the credit standing of the drawees.

A second type of bill is the commercial bill, drawn at short sight. In the course of the exportation of goods, it frequently becomes necessary to finance the shipments by the use of commercial bills having a life of less than 30 days. These bills are accompanied, as a rule, by shipping documents, and are apt to be payment bills.

Bankers' Long Drafts.—Bankers' long drafts are usually divided into three main types: (1) bills drawn in the regular course of business, (2) bills drawn in the course of lending foreign money, (3) finance bills.

1. *Long Bills Drawn in Ordinary Course of Business.*—A banker frequently is approached by a customer who has imported goods from abroad the payment for which is not due until some later period. This importer might have at hand available cash to settle the transaction and would like to do so. Probably the cheapest method of settling such a transaction would be for the importer to buy a bankers' draft from the bank, which would mature at approximately the same time that the bill financing the original trade transaction matures. The price that he would have to pay for the bankers' draft would be less than he would have to pay for the necessary funds to pay the original bill when it matured.

2. *Bills Issued in the Course of Lending Foreign Money.*—American and European bankers are constantly engaged in making loans in various parts of the world, and the actual transfer of funds is done chiefly through the use of bills. Thus, for example, a New York banker decides to loan a million dollars in the Berlin money market, and after the appropriate arrangements have been made, the Berlin correspondent of the New York banker draws a 60- or 90-day sight draft on the New York bank for $1,000,000, selling the draft in the Berlin market and lending the proceeds as directed by the New York banker.

3. *Finance Bills.*—These are also used for the purpose of transferring funds between bankers located in different countries. A difference of opinion exists among authorities as to the exact difference between the loan bills and the finance bills. Cross says:[1]

[1] Cross, Ira B., "Domestic and Foreign Exchange," p. 207, 1924.

. . . In my opinion, there are some very essential differences between loan bills and the type that we shall henceforth call *finance bills*. In the case of the former, the initiative is taken by the foreign bank that wishes to place its funds or credit in the American market. In the case of finance bills, the initiative is taken by the American bank that is desirous of borrowing funds for its own personal use, or on joint account for the profit of itself and the foreign accepting bank. With loan bills, the American bank receives only its commission as an intermediary; with finance bills, it gets all the gain, minus the small acceptance commission charged by the foreign bank—unless the deal is carried through on joint account, in which case the two banks divide the profits between themselves. With finance bills, the risk of exchange is borne by the New York borrowing bank, or, if the deal is on joint account, the risk is borne by both banks; but with sterling or dollar loan bills, the New York bank assumes none of the risk of exchange. With loan bills, the borrower is a third party; with finance bills, the New York bank is the borrower.

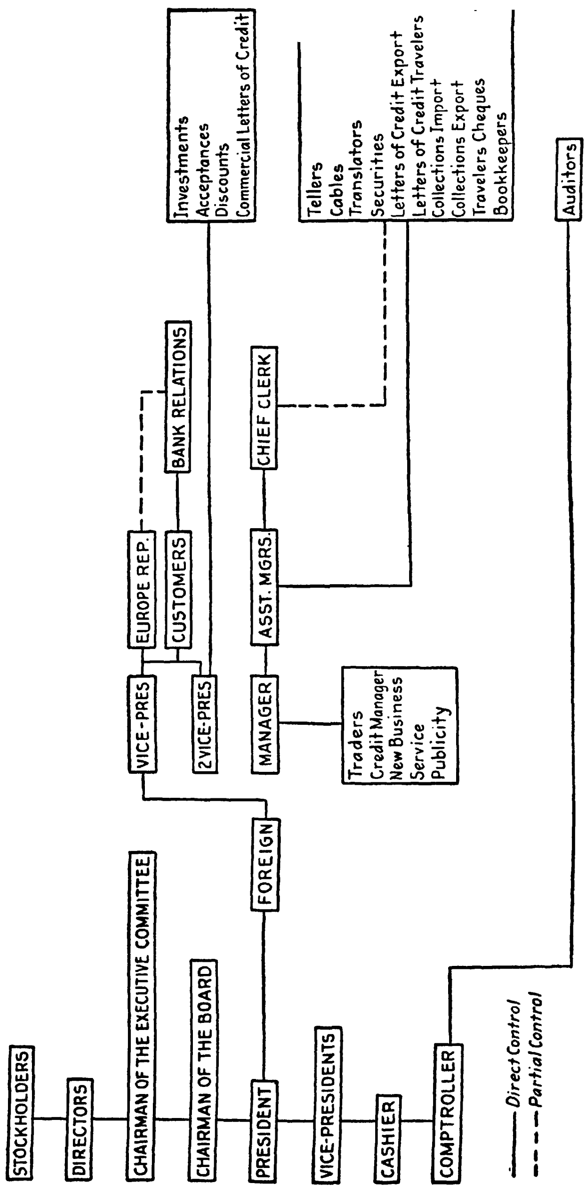
4. *Bankers' Drafts on Correspondents Abroad.*—International bankers as a rule keep large balances in many foreign centers, and therefore are constantly being called upon to draw on these foreign balances. This is a source of a great many of the bankers' bills appearing in the foreign exchange market.

The Organization of a Foreign Department.—Only the larger banks can afford to operate a separate department devoting itself exclusively to foreign exchange, and, as a matter of fact, most of the foreign exchange operations of American banks center in New York City, although some operations are conducted by the larger banks located in other financial centers.

The following diagram outlines the organization of the Foreign Banking Department of the Continental Illinois Bank and Trust Company, Chicago.

Obviously, the actual physical organization and distribution of work in the Foreign Division of a bank will vary widely in accordance with the policies of the institution, the volume of foreign business handled by the bank, the size of the bank itself, and the particular phases of foreign exchange work in which it may specialize.

Smaller banks will, in most cases, work through larger American correspondents, and will not have a Foreign Department, as the total volume of the foreign business they do probably does not require the full time of one clerk. But once the foreign business becomes large enough for the bank to carry it on in its own name, carrying its own accounts with foreign institutions, and otherwise acting independently in the foreign exchange field, a special departmental organization will


STOCKHOLDERS
DIRECTORS
CHAIRMAN OF THE EXECUTIVE COMMITTEE
CHAIRMAN OF THE BOARD
PRESIDENT
VICE-PRESIDENTS
CASHIER
COMPTROLLER
Auditors
FOREIGN
VICE-PRES
2 VICE-PRES
EUROPE REP.
CUSTOMERS
BANK RELATIONS
Investments
Acceptances
Discounts
Commercial Letters of Credit
MANAGER
Traders
Credit Manager
New Business
Service
Publicity
ASST. MGRS.
CHIEF CLERK
Tellers
Cables
Translators
Securities
Letters of Credit Export
Letters of Credit Travelers
Collections Import
Collections Export
Travelers Cheques
Bookkeepers
Direct Control
Partial Control

have to be built up to handle the foreign affairs. This is not only true because the volume of work would require it, but is of especial importance because of the extremely technical nature of the transactions involved, and the degree to which they differ from the ordinary domestic banking operation, both in principle and in the mechanical details connected therewith.

The organization of a typical Foreign Department of a large New York bank may be outlined as follows:

1. Commercial Credits Division:
    a. Import Credits
    b. Export Credits
    c. Collateral Section
2. Foreign Bookkeeping Section
3. Exchange Division
4. Travel Section:
    Letters of Credit
    Travelers' Checks
5. New Accounts Section
7. Allied Departments:
    a. Telegraph and Cable Department
    b. Translation Department

The relations existing between these departments, and the work handled by each of them will be discussed in detail as the various instruments used in foreign exchange are taken up, one by one.

The Foreign Office.—At this point, however, it might be well to mention the difference between a foreign office and a foreign branch of an American bank. In the case of the foreign office, it merely represents the American bank in the foreign city. It does not carry on a banking business, and it does not compete with the local banks in the foreign countries in any way. It merely represents the American bank in dealing with the foreign banks and foreign customers.

The Foreign Branch.—But in the case of the foreign branch, an actual banking business is carried on in the foreign city, in competition with local banks there, and the branch furnishes a complete banking service to the community similar to that of the home office. A number of the larger New York banks maintain branches in the more important foreign cities which carry on such a banking business; the National City Bank, for example, has over one hundred foreign branches.

The detailed handling of the work of the Foreign Department will now be taken up and discussed.

COMMERCIAL CREDITS DIVISION.[1] IMPORT CREDITS

Establishing of Import Letters of Credit.

The commercial letter of credit is the recognized medium for financing importations of merchandise. It protects the importer, first, because he is provided with the means of purchasing goods from a foreign country on a cash basis without being required to put up actual cash (provided his credit standing is satisfactory); and, second, because the foreign seller or exporter does not receive his money until he has surrendered documents evidencing shipment of the goods ordered. On the other hand, the exporter, if he is in possession of a letter of credit, knows that when the shipment has been made and the relative documents received, he can go to his bank and obtain the counter value.[1]

Imports credits are of the *circular negotiation type*, containing the following guaranty:

> We hereby agree with bona fide holders that all drafts drawn by virtue of this Credit, and in accordance with the above stipulated terms, shall meet with due honor upon presentation and delivery of documents as specified.[2] . . .

The beneficiary is thus enabled to negotiate his drafts thereunder with any bank or banker he may choose.

The majority of these credits are irrevocable, and do not require confirmation of the foreign correspondent. They may be issued in any currency and provide for drafts to be drawn at time or sight, on a bank in the country where the currency concerned is used. A typical form of such a letter of credit appears on page 318.

After the negotiations between the American buyer and the foreign seller in regard to price, date of shipment, etc., have been concluded, the buyer or importer makes application for a letter of credit based on these negotiations. Credits may be issued providing for drafts payable at sight, or after 30, 60, or 90 days, as may be required by the transaction being financed. The application form contains a form of guaranty which protects the bank until the formal obligation is signed by the client. On the reverse side of the application are noted the client's outstanding obligations and the line of credit extended. In every case, the terms of the application must be complete, consistent, and in accord with established practices, and the authority of the person signing the application to bind his firm must be ascertained.

[1] "How Business with Foreign Countries Is Financed," p. 22, Guaranty Trust Company of New York, New York, 1928.

[2] *Ibid.*, p. 25.

Guaranty Trust Company of New York
Foreign Department

Letter of Credit No. New York,

Gentlemen:

We hereby establish our irrevocable credit in your favor for account of

available by your drafts drawn at on the

Guaranty Trust Company of New York, New York

for any sum or sums not exceeding a total of

accompanied by commercial invoice, consular invoice, ocean bills of lading

evidencing shipment of

SPECIMEN

OFFICE COPY

Insurance

Ocean Bills of Lading must be drawn to the order of

The amount of each draft negotiated, with the date of negotiation, must be endorsed hereon.

All drafts drawn under this Credit should bear the clause "drawn under G. T. Co. of N. Y. Letter of Credit No. dated New York, "

We hereby agree with bona fide holders that all drafts drawn by virtue of this Credit, and in accordance with the above stipulated terms, shall meet with due honor upon presentation and delivery of documents as specified to the Guaranty Trust Company of New York, New York, if drawn and negotiated on or before

Yours Respectfully,

The clerk handling the transactions then prepares the following documents:

1. Copies of the letter of credit:
   a. Original letter of credit
   b. Client's copy
   c. Obligation to be signed and returned by the client
   d. Office copy
   e. Copy for the paying bank (when issued in a foreign currency).
2. Cable, if credit is to be advised by cable. The cable is sent through a foreign corespondent, and *test words* are used to insure genuineness of the cable.
3. Auditor's stub for the credit issued.
4. *Binder Sheet* for recording payments effected and documents received, and for indicating the terms of the credit.

5. **Letter-of-credit folder:**
   - *a.* Original application for credit
   - *b.* Copy of the credit
   - *c.* *Binder Sheet* in case of dollar credits.

     With foreign currencies, *binder sheets* are filed in a book arranged alphabetically by client's names, and divided into two groups—*Sterling* and *Other*.
6. Form letters.

All these documents and forms must be carefully checked. Reference is then made to the *condition cards*, where a record is kept of the various arrangements with different customers, and the appropriate commission rate is entered on the binder sheet.

The head, or assistant head, of the division once more checks the correctness of the credit, and signs it. It is then signed by the officer in charge, and is complete.

The large New York banks also issue domestic or import credits on behalf of other banks in the interior of the country. These letters are issued in the capacity of agent for the interior banks, since most of them, particularly the national banks, do not have the power to be guarantors of the city banks in such transactions.

Drafts and Documents under Import Letters of Credit.—Use of the letter of credit is effected by drawing drafts under it. These drafts are presented through three sources: (1) over the window, or through some other New York bank; (2) through the collection department; (3) directly through the mails.

To the draft will probably be attached the shipping and other documents, in the following order:

1. Draft
2. Commercial invoice
3. Consular invoice
4. Weight list, or other special documents
5. Insurance certificate
6. Bill of lading.

These documents will, perhaps, bear a little explanation.

Draft.—The draft must be scrutinized carefully, particularly in regard to the details of: Names, date, tenor, amount, whether payable in gold dollars or "United States currency" and whether first or second exchange. This last is important, as the drafts are often made out in duplicate or triplicate and forwarded by different routes.

Commercial Invoice.—There is nothing particularly unusual about the

commercial invoice. It should be made out by the beneficiary of the credit, and should be for the cost of the goods, only, unless the credit specifies otherwise. The merchandise should be described in full, with marks and number, and transportation prepaid if necessary; if not, the invoice should indicate whether the values given are c.i.f., f.o.b., or invoice values.

Consular Invoice.—This invoice must agree with the commercial invoice, but in addition must be signed by the shipper, and certified by the United States consul at the port of embarkation.

Insurance.—The insurance certificate should be for marine insurance covering the goods in transit to an amount at least equal to the invoice value. On its face should appear a description of the merchandise, the steamer's name, the port of shipment and destination, the route, the date, to whom the loss is payable, and indorsement.

Bills of Lading.—In the case of import credits, the bill of lading must be of a steamship company, and not a *forwarder* or *charter party* bill of lading, unless specifically mentioned or permitted. It must be signed by the captain or agent of the steamship company. The date must come within the time specified in the letter of credit, and never later than the expiration of the credit. It should be made out to the accepting bank, or indorsed on the back by the shipper. The destination and port of shipment should agree with those mentioned in the credit. Merchandise, quantity, marks, numbers, and weights must agree with the commercial invoice, and there must be no notation of *short shipments* or *quantity shut out,* nor notations qualifying accepting of the goods in *good order.* If the bill of lading is c.i.f. (cost, insurance, and freight), or c.&f. (cost and freight), then freight must be paid by the shipper. All corrections or erasures must be initialed.

Other Documents.—In addition to the documents just described, certain others are sometimes attached in the case of shipments of various kinds of merchandise. These are such papers as weight notes, health certificates, analysis certificates, description of merchandise, quantities, weights, etc.

Delivery of Documents to Customers.—On sight items, the drafts are detached and stamped *paid* and documents are routed to the collateral desk for delivery to the customer. On time items, a *trust receipt* is attached to the documents, which are routed through the collateral clerk to be held until the steamer arrives, or for immediate delivery against the trust receipt.

The acceptance stamp is placed across the face of the draft itself. This stamp gives the following information:

No..............................
Accepted
Date............................
Payable at......................
Name of Accepting Bank
Signed..........................
Signed..........................

In order to comply with the requirements of the Federal Reserve banks covering eligibility for rediscount, the acceptances are also stamped at the right hand edge with a stamp reading as follows:

This acceptance arises out of a transaction involving importation
of..............................
from............................
to..............................
Name of Accepting Bank

Import letters of credit may also be drawn on foreign offices or correspondents, in terms of foreign currencies. The documents are received directly through the mail from abroad, showing the details of sight drafts paid there against to the debit of the Nostro [1] account, or particulars of a time draft accepted against them, which are debited to the Nostro account at maturity. Documents under sterling credits are most important from the standpoint of volume.

Sterling Sight Documents.—The clerk in charge of handling exchange items will endeavor to sell the customer the necessary sterling exchange to cover the sight item. A pro-forma exchange contract will then be filled out and approved by the exchange trader who fixed the rate. It is then converted into dollars at the rate fixed, the commission and interest calculated, and the dates of payment in London and of reimbursement in New York entered.

Sterling Time Drafts.—The posterior maturity date on which the draft is due and payable in London, and the New York due date must be ascertained. The New York due date is fixed about 12 days before the London date, and on this New York due date the American bank

[1] *Nostro* account means *our* account. It is the account which an American bank carries with its foreign correspondent in the terms of the foreign currency. For example, if the Guaranty Trust Company of New York deposited £25,000 with the Midland Bank of London, the Guaranty Trust Company would regard that account as a Nostro account.

should be placed in funds to be remitted to London by mail to cover the draft.

An acceptance advice is mailed to the customer, giving the details of the draft, maturity dates and the details of the shipment of merchandise. The documents are turned over to the collateral clerk to be held until the steamer arrives, or are delivered immediately to the customer against a trust receipt as with dollar import letters of credit. Documents under other foreign currency credits are handled in a similar manner.

Reimbursements of Payments and Acceptances under Import Credits.—Under dollar credits, the accepting bank is to be reimbursed in terms of dollars, so reimbursement is effected by charging the client's account for the amount, or else by charging *Accounts Receivable* and sending the client a bill.

Under foreign currency transactions, when a sight payment is effected abroad, the account of the American bank is charged immediately. The American bank then communicates with its client for instructions. If the client instructs the bank to purchase, for his account, a cable transfer in the amount of the transaction, a rate is secured from the foreign exchange trader, and the cable is bought. The contract is then recorded, and converted into dollars at the rate indicated, usually including the commission and interest from the date of the debit in the Nostro account to the date of effected cable transfer. The client's account is then charged with the total amount and the bank's Nostro account is credited.

A banker's sight draft in the currency concerned may also be accepted for reimbursement, if it is drawn on a first-class bank, or it may be that the client has previously contracted with the Exchange Division for future delivery of foreign currency to reimburse the bank for the acceptance. Another possibility is that the client may have a cable contract with another bank. In this case, the client is instructed to what bank abroad the funds should go, and a confirmation is obtained from the other bank that the amount has been cabled.

Maturing Foreign Currency Acceptances.—As previously explained, foreign currency acceptances have New York due dates, some days in advance of the actual maturity of the acceptance abroad. On this date, the bank communicates with its client, and reimbursement is made in much the same manner as for sight transactions. If the client wishes to cover on the New York due date, he may do so with a check in the foreign currency; or he may arrange to have funds cabled a day or two before the actual due date abroad.

When clients desire to anticipate the payment of an acceptance,

paying in advance of the due date, an allowance is made for interest covering the period of anticipation, the rate depending on money rates here and abroad.

EXPORT CREDITS

The Guaranty Trust Company of New York makes the following statement in connection with credits for exports:

> . . . A large proportion of this (export) business is being transacted against credits established by American banks. That is to say, when an American bank letter of credit is stipulated in the negotiations for the purchase of goods or merchandise from an American seller, and the deal is concluded, the foreign buyer arranges for his local bank to establish with its New York bank correspondent a credit expressed in dollars in favor of the seller. On receipt of these instructions, frequently by cable, the American bank establishes the credit and notifies the seller of the details, quoting the amount, the documents required, etc. In due course the seller prepares the goods or merchandise for shipment, receives the necessary documents, and presents them to the bank issuing the credit. The bank, after carefully examining the draft and documents and finding them in accordance with the terms of the credit, pays the amount involved.
>
> Generally speaking, letters of credit covering exports are either irrevocable or revocable. The irrevocable letter of credit is the more satisfactory, as it is a definite obligation of an American bank to pay a certain amount of money under specified conditions and within a fixed period, and the credit cannot be withdrawn or canceled within that period, except with the consent of the beneficiary. The revocable form, however, while it can be withdrawn or canceled at any time, is not without its advantages. When long-established relations exist between buyer and seller, the revocable credit is established by the buyer as a matter of good faith and is accepted and acted upon by the seller. For example, most of the larger cotton exporting houses of the United States accept the revocable form. They have resident representatives in continental Europe who are familiar with conditions prevailing in the various countries, and have opportunities of judging at first hand the standing and reputation of cotton buyers.[1]

As will be noted from the quotation, export credits lend themselves to the following classification:

- Revocable:
  - Sight
  - Time
- Irrevocable:
  - Sight
  - Time

[1] "How Business with Foreign Countries Is Financed," Guaranty Trust Company of New York, New York, 1928.

The revocable credits are subject to revocation at any time by the American bank, with or without notice to the beneficiary. Irrevocable credits cannot be canceled without the consent of the beneficiary. Sight credits provide for drafts drawn at sight. Time credits provide for drafts drawn with a usance such as 30, 60, or 90 days after sight.

In addition to this classification, it will be well to note certain other terms used.

Clean credits provide for payment or acceptance merely upon presentation of drafts or receipt, with no further documents.

Confirmed credits are credits of another bank to which the confirming bank has added its assurance that the opening bank will perform its obligations thereunder. British banks use the terms as synonymous with *irrevocable.*

Domestic credits arise when both client and shipper are in the United States, and cover shipments from one point to another within the United States.

Revolving credits provide that the principal amount of the credit will again become available either upon notice to the beneficiary, or after a lapse of a given period, as weekly or monthly. It must be indicated whether the credit is cumulative or non-cumulative.

Reimbursement Credits.—Under these credits, the American bank, instead of charging the foreign bank's account with it for payments effected, reimburses itself by drawing its own drafts against another bank designated.

Advices represent a variety of transactions in which the American bank does not issue its own letter of credit, and incurs no liability.

Negotiation credits are issued by other banks in a foreign currency and provide for drafts on a bank in a foreign city, usually London. Such drafts are purchased at the buying rate for drafts of that tenor after the documents have been found to comply with the credit.

Issuance.—Requests for export credits are approved, when the amount comes within the prescribed lines and the conditions are consistent with the policy and practice of the bank. Where no credit lines for the purpose have been established, the transaction must be approved by the officer in charge. Signatures on mail credits must be verified by the signature clerk, and cables must contain a test word. The actual credit is then prepared. Standing instructions are on file under the name of the opening bank and the name of the beneficiary which will govern, and must be incorporated in the credit unless superseded by the application itself.

Forms to Be Used.—The forms to be used in the preparation of the letter of credit are:

1. Letter of credit itself:
   Original
   Copy for correspondents
   Two file copies.
2. Form letter to opening bank, acknowledging instructions and enclosing copy of the credit.
3. Auditor's stub.
4. Letter of credit folder:
   What account to be debited
   Disposition of documents
   Commission to be charged
   Shall payment of credit be advised by cable?
   Are partial shipments permissible?
   Special instructions.
5. Commitment sheet:
   Show details of credit issued and line extended to that particular client.
   Total amount of collateral, to protect their obligation.

Drafts drawn under these credits may be presented: (1) over the counter; (2) through the mail; (3) through the Loan and Collection Department. The documentary clerk checks over the draft and such of the following documents as may be attached and required in the particular case:

1. Invoices: commercial, consular, and certified
2. Certification of origin
3. Weight note
4. Weight certificate
5. Inspection certificate
6. Quality certificate
7. Analysis certificate
8. Insurance certificate
9. Bill of lading.

COLLATERAL SECTION

To protect itself against possible loss on acceptances, the accepting bank usually demands some form of collateral from its clients. The forms most commonly in use are:

Shipping documents
Warehouse receipts
Trust receipts
Negotiable securities
Trade acceptances and other domestic receivables
Foreign collections
Subsidiary letters of credit

Other forms:
Margin accounts
Foreign currency accounts
Liens on other accounts
Liens on excess collateral held by Loan Department
Securities held abroad for our account
Shipping documents and warehouse receipts held abroad for our account.

Of these, the shipping documents are the most common form of collateral.

For convenience, all forms of collateral, and the necessary transactions in connection therewith, are handled by a special section of the Commercial Credits division known as the *Collateral Section.*

Under sight credits, the acceptance is paid, and a memorandum made of the documents attached. These documents are then sent to the customer on a simple receipt listing the items. In the case of time credits, the documents are released against payment of the relative acceptance, or against a trust receipt, as explained below.

Trust Receipt.—The form of trust receipt in general use appears on page 327.

A careful reading of the trust receipt, itself, will reveal the purposes for which it is issued, and the conditions surrounding its use. It is, at best, a makeshift form of collateral, and its actual worth depends upon the integrity of the client to whom it is issued. But, as the client must have the original documents in order to unload the goods, and store them, sell them, or ship them to the interior, the trust receipt must be employed. If an incoming shipment is to be warehoused for a time, before sale, the warehouse receipt will be deposited with the bank upon the completion of the warehousing, and released under another trust receipt when the goods are ready for final disposition.

Trust receipt *lines* are established for the various clients, the same as acceptance lines, and the amount of these *lines* limits the amount of goods which will be released to each client under a trust receipt. Before any documents are released on trust receipt, an officer must approve, and if no trust receipt line has been established, or this line has been exceeded, the approval of two officers is necessary.

Warehouse Receipts.—When the merchandise has not been sold, and the customer is not entitled to full trust receipt accommodation as described above, warehouse receipts may be used as collateral. The shipping documents may be released temporarily on a trust receipt, to permit entry at the Customs House and storage of the goods, but the warehouse receipt must be surrendered in liquidation of the trust receipt; or the shipping documents may be released to a Customs House broker, with instructions to return the documents to the bank.

TRUST RECEIPT

New York City ....19......

Received from the Guaranty Trust Company of New York, for one of the following purposes as indicated by (x).

☐ 1. For Export Shipment.

☐ 2. For Warehouse.

☐ 3. To Exchange for Domestic Order Bills of Lading (Railroad or Steamship).

☐ 4. For immediate delivery to.., Who have/has purchased the same for $.....................................payable .... and to obtain from the purchaser the proceeds of the sale.

☐ 5. For

the goods and merchandise specified in the documents described below, both such documents and said goods and merchandise belonging to and being the property of the said Trust Company, and in consideration thereof I/we hereby agree to hold said goods and merchandise in trust for it and as its property and to deliver over to the said Trust Company or its assigns, immediately upon the receipt thereof by me/us, and in any event not later than (Date) ....any one of the following representing the goods and merchandise described below according to the purpose for which the original documents are withdrawn:

1. Complete Set of Order Ocean Bills of Lading.
2. Negotiable Warehouse Receipt of Independent Warehouse, Inc., or other warehouses satisfactory to said Trust Company.
3. Domestic Order Bills of Lading. (Railroad or Steamship.)
4. Proceeds of the sale of such goods or merchandise, it being understood that immediately upon receipt by me/us of such proceeds the same shall be delivered to the said Trust Company in whatever form collected and whether or not my/our obligation to it shall have matured. It is understood that such proceeds are to be applied by said Trust Company against my/our indebtedness to said Trust Company, whether due or to become due. However, if such proceeds be in notes, bills receivable or acceptances, they shall not be so applied until paid, but held until maturity by said Trust Company, with liberty meanwhile to sell or discount and so apply the net proceeds.
5.

SPECIMEN

The delivery herein is temporarily made to me/us for convenience only, without novation, or without giving me/us any title to the documents or the goods and merchandise they represent, except as trustee and agent for the said Trust Company for the purposes herein indicated.

Said Trust Company may at any time cancel this trust and take possession of said goods and merchandise or any of said documents or of the proceeds of the same wherever said goods and merchandise and documents or the proceeds thereof may then be found or located, and in the event of suspension, proceedings in bankruptcy or assignment for the benefit of creditors on my/our part or of the non-fulfillment of any obligation or of the non-payment at maturity of any indebtedness on my/our part to said Trust Company then in any such case, all obligations, acceptances, indebtedness and liabilities whatsoever shall forthwith mature and become due and payable.

The said goods and merchandise shall at all times at my/our expense, be fully insured against loss by fire and any other risk that said goods and merchandise may be subject to. On demand, the insurance policies or certificates of acceptable companies will be deposited with the Guaranty Trust Company of New York, the said Trust Company to be designated in the policies as the Assured in the following form: Assured: The Guaranty Trust Company of New York for account of whom it may concern. Loss to be adjusted with..and payable to the Guaranty Trust Company of New York for account of whom it may concern.

The undersigned in further assurance, agree that insofar as the undersigned may make entries or records of transactions herein set forth or provided for in the books of account of the undersigned, such entries shall definitely indicate that said merchandise and documents and the proceeds thereof are the property of said Trust Company.

Receipt of a copy of this Trust Receipt is herewith acknowledged.

DESCRIPTION OF DOCUMENT	QUANTITY	GOODS AND MERCHANDISE (GIVE MARKS AND NUMBERS)	VALUE

Signed...

Usually, imported merchandise subject to duty is entered at the Customs House *in bond* and payment of the duty deferred until the time of sale. The merchandise must then be stored in a *bonded warehouse*, and warehouse receipts covering it must be accompanied by a signed *withdrawal entry* in triplicate.

When warehouse receipts serve as collateral, partial releases may be made against a trust receipt, for delivery to the purchaser, or against payment of cash in liquidation of a proportionate liability. If the warehouse receipt is negotiable, the delivery must be indorsed thereon.

Miscellaneous Collateral.—In addition to the usual shipping documents, trust receipts, and warehouse receipts, a number of other forms of security are possible as collateral protection under acceptance credits, such as negotiable securities, receivables, margin accounts, foreign currency accounts, subsidiary letters of credit, liens, and guaranties.

BOOKKEEPING SECTION

The Foreign Department must, of necessity, keep extensive and accurate records of its transactions and the positions of its customers. These records are, however, quite complicated, and the mechanical and accounting processes intricate, so that a detailed discussion of the work of the bookkeeping section would be of little value here. Only a brief description of the records kept, and the entries made in connection with the most important classes of transactions, will be noted.

Export Customers' Liability Records.—In connection with export credits, the following records are kept:

1. Unused credits outstanding:
   a. Unused time credits (confirmed and unconfirmed)
   b. Unused, confirmed sight credits
   c. Unused, unconfirmed sight credits.
2. Acceptances outstanding:
   a. Export acceptances
   b. Acceptances to create dollar exchange.
3. Control accounts covering each of the groups of unused credits
4. Export acceptances anticipated
5. Diary of maturing export and dollar exchange acceptances
6. Divisional settlement book (journal)
7. Accounts receivable record
8. Difference book.

The issuance of a credit is first recorded in the issue book. Individual credits are posted to *unused credits outstanding* under the name of the foreign bank for whom the credit is issued. Sight payments are recorded in the divisional journal, and the amount of the contingent liability to be reduced is noted. Acceptances executed are posted from the acceptance book, after reduction of unused time credits outstanding. The record serves as the source of entry for increase of acceptances outstanding.

Import Customers' Liability Record.—In connection with Import Credits, a similar set of records is kept, as follows:

1. Unused credits outstanding:
   a. Dollars
   b. Sterling
   c. Sundry currencies.
2. Acceptances outstanding:
   a. Dollars
   b. Sterling
   c. Sundry currencies.
3. Control accounts covering each of the above groups of unused credits in the respective currencies, and covering group *b* and *c* of Acceptances outstanding.
4. Import acceptances anticipated
5. Diary of maturing import acceptances
6. Divisional settlement book
7. Credits to London sterling draft account
8. Maturing continental long drafts
9. Accounts receivable book
10. Difference book.

The principal difficulty in keeping these records is the recording in the original currencies, and then transferring the amounts into dollars at nominal rates.

EXCHANGE DIVISION

The general activities of the Exchange Division are the execution of all transactions pertaining to the purchase or sale of foreign exchange in the form of drafts, mail transfers, cables, documentary bills, clean bills, foreign currency, etc.

Window.—The Foreign Department of a large bank has windows and counters similar to those found in the banking rooms of any bank for the accommodation of the customers. The men at the windows interview the customers, and applicants for purchases of drafts, mail transfers, cable transfers, etc., and see to the satisfaction of their wants. The sorting of the incoming mail, and the care of the bank's drawing service is also taken care of by this section.

Requests for the purchase of checks and cables are immediately prepared for execution. In their preparation, the clerks must verify the signatures, and see that the bank receives good cover, or that the depositor has the proper amount on deposit. If the customer has a spot contract, this is attached; if not, a rate is secured, and applied to the transaction.

Requests for dollar payment by mail, cable, etc., orders from other departments of the bank, advices from country banks issuing drafts

under the city bank's protection, etc., are all received at the window and prepared for execution. Advices from country banks are carefully examined to ascertain the proper rate, drawee bank, and that the cover is in order.

Requests from interior banks for the use of drawing facilities are passed upon by the officer in charge of the territory before being extended. If the service is extended, then drafts and letters of credit are printed, and furnished the interior bank for use in this connection.

Drafts drawn by foreign institutions in foreign currencies, when received, are carefully examined, and the signature verified. The buying rate is then obtained from the Trading Division and the item paid by treasurer's check, or by credit to a ledger account.

Contracts for Future Delivery.—Contracts for future delivery of foreign exchange are entered into with banks, brokers, commercial concerns, and individuals. Those maturing at a fixed date are entered in a tickler, and are taken up by the customer when the time comes. If they do not mature at a fixed date, negotiations are renewed with the customer during the period.

Certain customers, indicated by the credit division, are required to maintain margin against future contracts, for the protection of the bank.

Cable Transfers Purchased and Orders Received from Foreign Correspondents to Effect Payments in Foreign Currencies.—This desk sees that such contracts are properly authorized, and that the calculation of the dollar equivalent is properly made and checked. A satisfactory confirmation of the credit must be received from the seller, and payment for exchange so purchased must eventually be effected, either by a credit to an open account on the books, or delivery of a treasurer's check for the amount due the seller.

This desk also handles orders received from foreign correspondents to pay banks, commercial houses, or individuals in this country stated amounts in foreign currency. The custom is to liquidate such payments in American dollars at the buying rate for exchange on the country in question on the date the payment is made, although occasionally payments are made by draft in favor of the payee, drawn on the country concerned.

Cable Transfers Sold.—*Spot Trades.*—Spot trades are entered into with banks and bankers in New York and out of town, covering exchange operations payable on value dates here and abroad one or two days hence. Sometimes these sales are made directly to the purchaser, and at other times they are made through the medium of brokers.

Dollar and Miscellaneous Cables.—These orders are received through the medium of out-of-town correspondents, banks and bankers out of town, in the city, and correspondents abroad. Dollar transfers are paid abroad at the paying bank's buying rate for exchange on New York.

Transactions Emanating from the Window.—From time to time, individuals present themselves, giving orders to be executed by cable transfer, for which they pay cash, or have their accounts charged.

Drafts and mail transfers are issued in foreign currency and in United States dollars, their preparation being similar to cable items.

Bank Drawings.—City banks permit drafts to be issued under their protection, drawn in foreign currency and in United States dollars on their foreign correspondents.

Margin Accounts.—Margin accounts are maintained in New York by various New York brokers, in conjunction with firm accounts carried by them in foreign branches. In the event of an overdraft in any such account abroad, sufficient dollar margin must be deposited here to cover. Entries are made upon receipt of cable advices from the branches, giving dollar amounts and rates at which they are to be converted, so that memorandum accounts may be kept in New York showing the balances of the various accounts abroad. Payments are forwarded abroad by cable at the request of principals in New York to the debit of the various accounts, if the balance is insufficient, or upon receipt of additional margin to cover. Reconcilement of the accounts is done by the foreign bookkeeping section.

Cashier's Cage.—The cashier of the Foreign Department has duties similar to those of a main-office paying teller. He receives all monies from the Commercial Credit Division for travelers' letters of credit and travelers' checks sold by them, and disburses cash to them for payments under Letters of Credit and Clean Credits against special forms of drafts, signed by the beneficiary and properly authorized. He has under his control all blank travelers' checks, and receivables from the telegraph and cable division, and he receives all checks or cash in payment. He also has under his control all foreign monies, and receipts of checks in payment of exchanges sold either by draft, mail, transfer or cable, and deliveries over the counter, as well as checks in payment of exchange purchased.

Documentary Bills and Clean Checks.—Foreign buyers place orders for spot or future delivery of cotton and other merchandise with southern cotton houses, and others. These orders give rise to the necessity of entering into spot and future exchange contracts.

Through different foreign exchange brokers in Memphis, Dallas, Houston, and other cities, bids for sterling and franc bills are telegraphed during the day, according to the exchange market. As such bids are made and accepted by shippers, telegraphic advice is received from the brokers, and entered on the department records. A similar procedure takes place in connection with contracts made direct with the shippers.

Application of Exchange Contracts.—The contract man, upon receipt of the documents, makes application of the delivery against the contract specified by the customer. The terms of the contract must be applied with respect to the tenor, principal, drawee, time of delivery, etc. If documents are presented before or after the time called for in the contract, the exchange trader must decide whether a penalty shall be levied, as at the time the contract was drawn future exchange may have been at a premium or a discount. In forwarding time bills to correspondents for collection, it is always specified how the acceptance is to be disposed of. When favorable to the American bank, it enters into discount contracts with the correspondents and specified amounts of these contracts are discounted at the rates agreed upon.

Securities.—Exchange may be purchased with negotiable securities instead of shipping documents as collateral. When so done, a special letter is written to the correspondent bank, instructing it to surrender the securities to the drawee against payment of the draft, which is forwarded separately as a clean item. The securities in transit are insured.

Foreign Money.—Orders for the purchase and sale of actual foreign currency are received by mail, telegraph, and by customers applying at the window. These demands are taken care of at once from a supply of foreign currencies kept in the vaults for the purpose.

Trading Division.—The Trading Division, although in many ways the heart of the Foreign Department, will require but little space in a work of this character.

From the standpoint of organization, it is small, with an officer in direct charge, two or three traders, a senior record clerk, and perhaps two or three others. The purpose of the division, as its name indicates, is to execute the purchase and sale of foreign exchange for immediate or future delivery, and includes dealings in: Cable transfers, drafts or demand bills, short- and long-time bankers' and commercial bills, and documentary bills. The operations are carried on with foreign and domestic dealers in exchange, commercial firms or agencies, individuals, or through intermediary foreign exchange brokers.

By telegraph, cable, and telephone, the traders keep in constant touch with foreign exchange conditions in the markets of the world as well as with interest and discount rates, because of their subsequent great influence on the rates of exchange, themselves. Bids and offers are made for exchange over private telegraph systems, to out-of-town banks, and customers, through various representative offices.

TRAVEL SECTION

American travelers abroad must provide themselves with funds for their expenditures. One of the best ways of doing this is by means of a traveler's or circular letter of credit, which is readily negotiable in practically all parts of the world, and particularly at banks with which previous arrangements have been made by the issuing bank. These travelers' letters of credit may be drawn in dollars, or in foreign currencies.

The holder obtains money under one of these letters of credit by drawing drafts on the issuing bank, and selling these drafts to various foreign banks or agencies at whatever may be the buying rate for sight checks on New York. Each check so drawn is entered on the back of the letter of credit, so that the traveler has a record of the amounts he has drawn, and the unused balance. When the last draft is drawn, the used letter of credit is customarily attached to it, and goes through to the issuing bank for cancellation.

About one-tenth of such letters of credit are issued against cash on request by a customer, or other person properly introduced, the customer paying cash for the face amount of the letter, plus 0.5 per cent commission, with a minimum fee of $5. No interest is allowed, however, on a cash credit, so they are more frequently issued on a guaranty, usually with collateral security.

Travelers' Checks.—A somewhat more convenient method of carrying funds, particularly in smaller amounts, is the travelers' check. These checks are issued by various institutions, notably the American Express Company and the American Bankers' Association, and are sold by banks and bankers throughout the world. They are issued in

> . . . denominations of $10, $20, $50, and $100, and are negotiable at the current rate of exchange for checks on New York, the holders receiving value in the equivalent of the money of the country where they are staying. When the checks are issued, the holder signs each check in the upper left-hand corner in the presence of the person from whom he is to receive the funds. In this manner, the checks are immediately self-identifying, thus obviating delays.[1]

[1] "How Business with Foreign Countries Is Financed," p. 42. Guaranty Trust Company of New York, New York, 1928.

If the checks are lost or stolen, notice should be given to the bank from whom they were bought, in order that payment can be stopped, and the owner reimbursed for the lost checks, after furnishing proper protection to the bank.

Payments of Letters of Credit Issued by Correspondents, etc.—American banks, of course, act as paying agents for letters of credit issued by foreign banks, just as the foreign banks pay the drafts drawn under the letters issued by the American banks. When drafts drawn under such letters of credit are presented for payment, they are subsequently cleared by the cashier in the usual course of business, or are charged back to the bank in question.

NEW ACCOUNTS SECTION

Opening Accounts.—As with the bank at large, the Foreign Department must have new business, and facilities for taking care of this business when it is received. When a prospective customer desires to open an account, this section communicates with the Credit Department of the bank concerning the customer's credit file, and if this is satisfactory, the new account is opened. In case there is no credit file, at the time, or the information is not good, the customer is referred to an officer for a decision, and credit information is obtained as soon as possible.

Time Deposit Accounts.—Depositors of this class, as the accounts mature, are communicated with, and instructions requested as to whether to renew the account on a time basis, or to transfer the balance to a current account, immediately available.

Closing Accounts.—When, for one reason or another, an account is to be closed, the depositor gives instruction for the disposition of the balance, and if the account has been a particularly valuable one, a letter is written the depositor, thanking him for his past business, and expressing regret at the closing of the account.

Accounts Opened in Branch Offices.—From time to time an account is opened in a foreign branch, either in dollars or in the currency of the foreign country. If it is in a foreign currency, a contract is made with the Exchange Division at a definite rate, and a draft is issued on the branch to the order of the depositor's account, and sent to the branch, requesting the branch to open the account.

Accounts Payable.—Sometimes, remittances are received in the transit department, or the collection-payment division, for the credit of individual firms or banks for which the receiving bank has no account.

If the bank has no instructions concerning the disposition of the balance, the deposit is returned to the bank making it, or a letter is written to the party ordering the payment; or a cable may be sent asking for instructions.

Credit Lines.—The senior officer makes all decisions concerning the extension of credit lines.

Advances.—Advances may be created on the book, for certain periods of time, at fixed rates of interest.

Discounts.—The bank may be asked to discount drafts drawn on New York banks, and drafts declared payable in New York, bearing the indorsement of a particular bank. The senior officer will quote the rate of discount, and the bank account may be credited immediately, the bills coming by mail later. A memorandum is then sent to the Loan Department, requesting them to discount the bills, and credit the proceeds to a Special Overdraft account.

Letters of introduction may be given by this department to clients, or other persons properly introduced, for a variety of reasons. Likewise, incoming letters of introduction are received and handled through this section of the department.

ALLIED DEPARTMENTS

The Cable Department.—This department is usually considered in connection with the Foreign Department. It is, of course, necessary to do a large volume of business by cable, nearly all in code, and the banks have actual telegraph instruments in their own offices, and their operators telegraph the messages direct to the central office of the telegraph company, where they are put on the cables. The foreign banks have a similar arrangement, so that it is possible to get an answer from Europe within 5 minutes on matters requiring immediate action.

Translation Department.—There must also be experts in the various foreign languages used in international commercial intercourse, especially French, German, and Spanish, connected with the Foreign Department to assist in translating documents and handling correspondence with the non-English-speaking countries.

CHAPTER XXV

BRANCH AND CHAIN BANKING

In the field of business, the advantages of large-scale operations are generally appreciated, and have resulted in numerous amalgamations and consolidations of industries in this and other countries.

England, Germany, and other countries have extended amalgamations to the field of banking. In the case of the former country, most of the commercial banking business is done by five joint stock banks; in Germany, by six large banks. In this country, bank amalgamations and consolidations have proceeded with increasing rapidity during the past decade, due largely to the tendency of the times towards large-scale operation of enterprises of all types. The specific reasons advanced to explain bank consolidations are usually grouped under three heads:

First, the desire to remove competition; second, the desire to increase the resources of the bank in order that it may be in a position to take on larger accounts or to increase its banking facilities, which it can do at decreasing cost because of economies effected through large-scale banking operation; and third, the desire to obtain additional offices or to better the location of its central office.

The congestion of traffic in the central part of modern cities created many new business districts, and, consequently, within the cities there are many thriving business communities which require the service of banks with substantial resources. Many of the mergers have been encouraged in order to enable banks to meet this demand by acquiring offices in the newer business districts.

It is probable that the desire to increase resources has been the reason most commonly advanced when merger plans are announced. For example, in the case of the merger of the Bank of North America with the Commercial Trust Company, the stated reason was the desire to be better equipped to meet the needs of the business men of Philadelphia. Incidentally, the resulting Bank of North America and Trust Company had a combined capital, surplus and undivided profits of over $10,500,000, and resources of about $65,000,000. This contrasts with the combined capital, surplus and undivided profits of $5,500,000 of

either of the merging banks and of resources of about $35,000,000 in either case.

The increase in resources through consolidations is perhaps best illustrated by four mergers occurring in 1926. The resources of the Philadelphia-Girard National Bank immediately after the merger were over $250,000,000, with total capital employed of approximately $27,600,000, while prior to the merger, the larger of the two banks, the Philadelphia National, had resources of only $155,000,000 and capital employed amounting to around $17,000,000. Thus this bank has increased its resources by nearly $100,000,000.

The combined capital, surplus, and undivided profits of the Franklin Fourth Street National Bank was over $24,000,000 as contrasted to about $12,000,000 representing the combined capital, surplus, and undivided profits of the larger of the two merging institutions. The resources of the resulting bank immediately after the merger were over $160,000,000, contrasted with about $80,000,000 in the case of either of the individual banks making up the consolidation.

The merger of the Franklin Fourth Street National Bank with the Philadelphia-Girard National Bank, created in the resultant bank, the Philadelphia National Bank, an institution with capital, surplus, and undivided profits of $53,436,101, and resources of over $369,652,264.

Consolidation of National Banks under the Act of Nov. 7, 1918.—National banks proposing to consolidate under the act of Nov. 7, 1918, should advise the Comptroller of the Currency of the plan of consolidation under consideration and apply for his approval. If the condition of the banks is such as to warrant approval of the consolidation and the terms of consolidation are unobjectionable, instructions relative to the course of procedure, together with forms to be executed in connection therewith, will be furnished. The initial proceeding under the act, after the plan adopted has received the approval of the comptroller, is to have the directors of the two associations enter into an agreement covering the terms of the consolidation. If the form of agreement submitted does not include all that may be desired to be included in the proposed consolidation, the comptroller should be advised of desired changes or additions, and, if they meet with approval, an amended form, providing for such changes or additions, will be furnished.[1]

If an increase in capital is provided for, by the agreement between the directors of the associations, of an amount in excess of the total

[1] Instructions of the Comptroller of the Currency, Relative to the Organization and Powers of National Banks (1926).

capital of the existing banks, or if there is a provision in the agreement requiring the paying in of cash in addition to the transfer of assets to equalize the value of capital stock, or for other reason, it will be necessary to furnish a certificate sworn to by the president or cashier of the consolidated associations, showing that such increase has been paid in cash. In the event that the capital of the consolidated association is less than the capital of either one of the existing associations, it will be necessary to secure the consent of the Federal Reserve Board to such reduction, in the same manner as in case of reduction of capital of national banks.

Resolution of Shareholders under Act of Nov. 7, 1918.

When the approval of the comptroller has been secured to the provisions of the agreement for consolidation of the associations, and the agreement has been signed by the directors of each association and acknowledged before a notary public, it may be submitted to the shareholders. Notice of the meeting of the shareholders of each association to vote upon this agreement must be published for four consecutive weeks in some newspaper published in the place where the associations are located, and if no newspaper is published in the place, then in a paper published nearest thereto, and this notice must state the time, place, and object of the meeting. In addition to this published notice, the law requires a notice to be sent to each shareholder of record by registered mail at least 10 days prior to said meeting. When the agreement between the directors is ratified and confirmed by the affirmative vote of the shareholders of each such association owning at least two-thirds of its capital stock, a certified copy of the resolution, evidencing ratification and confirmation, should be sent to the comptroller. Upon receipt of the resolution, evidencing compliance with the requirements of law, etc., the comptroller will issue his certificate approving the consolidation. The agreement between the directors of the associations must be recited in full in the resolution of the shareholders, and the names of all the directors who sign the agreement and the officers before whom they acknowledge it should be typewritten.[1]

Consolidation when One Bank Is Placed in Liquidation.

Consolidation under this plan can only be effected by pursuing one of the following methods:

First, Without an increase of capital the directors of the absorbing bank may enter into a contract with the directors or agents of the liquidating association to purchase its assets, assume liabilities to depositors and other creditors, and to pay the value of assets purchased in excess of liabilities to depositors and other creditors, less any expenses incident to liquidation.

Second, By increasing the capital stock of the absorbing bank by an amount equal to that of the liquidated bank, the additional shares may be sold to stock-

holders of the latter, consent thereto having been previously obtained from shareholders of the absorbing association.

The National Bank Act makes no provision for the allotment of new stock when a bank increases its capital; but under the common law, where it has not been modified by statute, when a corporation has adopted a resolution to increase its capital, shareholders of the corporation have the right to participate in the increase in proportion to the number of shares held by each, and waiver of that right should be obtained before allotting any of the shares to others.

Provision having thus been made for shareholders of the closed bank, the directors of the continuing bank are at liberty to contract for the purchase of assets and the assumption of liabilities to depositors and creditors of the liquidated bank.

As the law is construed as requiring the payment of capital, original or on account of increase, in money, and not in *notes or like evidences of debt*, the right to accept stock or assets representing stock of the closed bank and to issue therefor certificates in the continuing bank is not recognized. In every such case shareholders of the closed association should be paid the value of their stock, either in cash or cashier's checks, the proceeds being available in payment of shares to which they may be entitled in the absorbing corporation.

Third, The remaining method is to place the interested banks in voluntary liquidation, organize anew under a different corporate title, and acquire, in the manner hereinbefore outlined, the business of the liquidating associations. This method enables the incorporators to place the stock as they may determine.

In any event, there should be a contract covering the transfer of assets and assumption of liabilities, and an examination of the assets to be taken over will be made by a national bank examiner at the expense of the bank acquiring the assets.[1]

Assumption of Liability for Circulation.—The national banking law provides that a national bank which is in good faith winding up its business for the purpose of consolidating with another national bank shall not be required to deposit lawful money for its outstanding circulation.

When it is desired to take advantage of this section, in addition to the adoption of the resolution by the directors of the liquidating bank authorizing the assignment of its bonds to the national bank with which it is to be consolidated, the comptroller requires the directors of the continuing bank to adopt a formal resolution by which they assume liability for the outstanding circulation of the liquidating bank.

Consolidation of National with State Bank, Act of Feb. 25, 1927 (Sec. 1).

That any bank incorporated under the laws of any state, or any bank incorporated in the District of Columbia, may be consolidated with a national banking association located in the same county, city, town, or village under the

charter of such national banking association on such terms and conditions as may be lawfully agreed upon by a majority of the board of directors of each association or bank proposing to consolidate, and which agreement shall be ratified and confirmed by the affirmative vote of the shareholders of each such association or bank owning at least two-thirds of its capital stock outstanding, or by a greater proportion of such capital stock in the case of such state bank if the laws of the state where the same is organized so require, at a meeting to be held on the call of the directors after publishing notice of the time, place, and object of the meeting for four consecutive weeks in some newspaper of general circulation published in the place where the said association or bank is situated, and in the legal newspaper for the publication of legal notices or advertisements, if any such paper has been designated by the rules of a court in the county where such association or bank is situated, and if no newspaper is published in the place, then in a paper of general circulation published nearest thereto, unless such notice of meeting is waived in writing by all stockholders of any such association or bank, and after sending such notice to each shareholder of record by registered mail at least 10 days prior to said meeting, but any additional notice shall be given to the shareholders of such state bank which may be required by the laws of the state where the same is organized. The capital stock of such consolidated association shall not be less than that required under existing law for the organization of a national banking association in the place in which such consolidated association is located; and all the rights, franchises, and interests of such state or district bank so consolidated with a national banking association in and to every species of property, real, personal, and mixed, and choses in action thereto belonging, shall be deemed to be transferred to and vested in such national banking association into which it is consolidated without any deed or other transfer, and the said consolidated national banking association shall hold and enjoy the same and all rights of property, franchises, and interests including the right of succession as trustee, executor, or in any other fiduciary capacity in the same manner and to the same extent as was held and enjoyed by such state or district bank so consolidated with such national banking association. When such consolidation shall have been effected and approved by the comptroller any shareholder of either the association or of the state or district bank so consolidated, who has not voted for such consolidation, may give notice to the directors of the consolidated association within 20 days from the date of the certificate of approval of the comptroller that he dissents from the plan of consolidation as adopted and approved, whereupon he shall be entitled to receive the value of the shares so held by him, to be ascertained by an appraisal made by a committee of three persons, one to be selected by the shareholder, one by the directors of the consolidated association and the third by the two so chosen; and in case the value so fixed shall not be satisfactory to such shareholder he may within 5 days after being notified of the appraisal appeal to the Comptroller of the Currency, who shall cause a reappraisal to be made, which shall be final and binding; and the consolidated association shall pay the expenses of reappraisal,

and the value as ascertained by such appraisal or reappraisal shall be deemed to be a debt due and shall be forthwith paid to said shareholder by said consolidated association, and the shares so paid for shall be surrendered and, after due notice, sold at public auction within 30 days after the final appraisement provided for in this act; and if the shares so sold at public auction shall be sold at a price greater than the final appraised value, the excess in such sale price shall be paid to the said shareholder; and the consolidated association shall have the right to purchase such shares at public auction, if it is the highest bidder therefor, for the purpose of reselling such shares within 30 days thereafter to such person or persons and at such price as its board of directors by resolution may determine.

The liquidation of such shares of stock in any state bank shall be determined in the manner prescribed by the law of the state in such cases if such provision is made in the state law; otherwise, as hereinbefore provided. No such consolidation shall be in contravention of the law of the state under which such bank is incorporated.

The words *state bank*, *state banks*, *bank*, or *banks*, as used in this section, shall be held to include trust companies, savings banks, or other such corporations or institutions carrying on the banking business under the authority of of state laws.

Branch Banking.—The result of amalgamations and consolidations is ordinarily, but not necessarily, the maintenance of one of the institutions as a central office and the others as branches. Under certain circumstances branches may be opened without consolidation with other banks. State laws vary in regard to this. At the present time, 20 states authorize branch banking, 23 states prohibit it, and 5 states have no specific provision relating to it.

1. States which by statute authorize branch banking: [1]

Arizona	Maryland	Pennsylvania
California	Michigan	Rhode Island
Delaware	Mississippi	South Carolina
Kentucky	New Jersey	Tennessee
Louisiana	New York	Virginia
Maine	North Carolina	Wyoming
Massachusetts	Ohio	

2. States which by statute prohibit branch banking: [1]

Alabama	Indiana	New Mexico
Arkansas	Iowa	Oregon
Colorado	Kansas	Texas
Connecticut	Minnesota	Utah
Florida	Missouri	Washington
Georgia	Montana	West Virginia
Idaho	Nebraska	Wisconsin
Illinois	Nevada	

[1] Fed. Res. Bull., December, 1929.

3. States which do not by statute specifically provide for branch banking:[1]

New Hampshire	South Dakota
North Dakota	Vermont
Oklahoma	

A rapid development of branch banking has taken place within those states authorizing it.

The greater proportion of the branches are located in the large urban centers. New York City, with 71 banks, operating 549 branches; Detroit, with 11 banks, operating 305 branches; Philadelphia, with 49 banks, operating 122 branches, are illustrative of city-wide branch banking. Most of the branch-banking systems in operation in this country are so-called one-branch systems, as shown in the following table:

SIZE OF BRANCH SYSTEMS FOR PARENT BANKS LOCATED IN LARGE AND SMALL CITIES; JUNE 30, 1929[1]

Size of branch system	Total	Parent banks located in cities			
		Over 100,000	50,000 to 100,000	25,000 to 50,000	Less than 25,000
1 branch	443	133	54	36	220
2 branches	153	68	14	18	53
3 to 5 branches	129	83	13	12	21
6 to 10 branches	38	24	3	3	8
11 to 30 branches	38	34	....	1	3
Over 30 branches	17	17			
Total	818	359	84	70	305

That branch banking has increased in the United States is shown by the table on the opposite page, indicating the growth of branch banking from 1865 to June 30, 1929.[1]

National Bank Branches.—The active competition between state and national banks led the comptroller in 1921 to authorize the establishment of branches by national banks within the cities in which the parent banks were located, in those states in which state banks were authorized by state law to establish branches in the cities in which the parent banks were operating, and in those states where the state laws

Date	Number of branches	Date	Number of Branches
1865 to 1869	1	1911	360
1870 to 1874	3	1912	416
1875 to 1879	3	1913	462
1880 to 1884	4	1914	507
1885 to 1889	8	1915	565
1890 to 1894	24	1916	626
1895 to 1899	48	1917	696
1900	60	1918	754
1901	71	1919	857
1902	95	1920	1,052
1903	120	1921	1,211
1904	148	1922	1,602
1905	166	1923	1,882
1906	221	1924	2,292
1907	250	1925	2,642
1908	275	1926	2,782
1909	305	June 30, 1927	2,989
1910	329	June 30, 1928	3,230
		June 30, 1929	3,440

have nothing to say one way or the other upon the subject of branch banking.

Later, the Supreme Court of the United States decided that the Comptroller of the Currency had no authority to grant to national banks the privilege of establishing branches. In consequence of this decision, the comptroller sanctioned the opening of *offices* by national banks within the city in which the bank was located. An *office* was supposed to differ from a branch in that it received and paid out deposits only; it was not supposed to perform any additional functions usually performed by a bank. Manifestly, the actual difference between an office and a branch was slight.

This situation was clarified to some extent by the passage of the McFadden bill in 1927. As a result of this Act, national banks, in so far as branch banking was concerned, were placed in a position comparable to the state institutions.

The provisions of that Act relating to branch banking are summarized in a form letter of the Comptroller of the Currency, dated March 3, 1927.

Section 5155, United States Revised Statutes

1. National banks having not more than one branch maintained and operated more than 25 years immediately preceding Feb. 25, 1927, may continue to maintain that branch.

2. State banks converting and national banks consolidating may retain and operate any branches in lawful operation Feb. 25, 1927.

3. New branches may be established in same city, town, or village, if state laws permit state banks to do so, except: none are permitted where population is less than 25,000; one, where population is not more than 50,000; two, where population is not more than 100,000; number within the discretion of comptroller where population is over 100,000.

4. Branches may not be moved except with consent of comptroller.

5. Branch defined as branch bank, office, agency, additional office, or any branch place of business.

The passage of this Act speeded up the number of branches opened or acquired by national banks, and between Feb. 25, 1927, when the Act became a law, and Oct. 31, 1927, 400 branches were acquired by the national banking system through the conversion or consolidation of state banks, while an additional 127 new branches were established by national banks under authority of the provisions of the Act.

Incidentally, in this connection it is interesting to note that since the enactment of the McFadden bill, the Bank of Italy was converted from a state bank into a national bank, and brought into the national system a branch-banking organization having 278 branches in operation at the time of the conversion. This system is the largest branch-banking system in existence in this country today.

American Branch Banking Abroad.—American banks have not engaged in foreign banking to the extent of their European competitors. The law regulating the right of national banks to operate branches follows.

Foreign Branch Banks.—Section 25 of the Federal Reserve Act, as amended by the Act of Sept. 7, 1916, contains the following provision:

Any national banking association possessing a capital and surplus of $1,000,000 or more may file application with the Federal Reserve Board for permission to exercise, upon such conditions and under such regulations as may be prescribed by the said board, either or both of the following powers:

First, To establish branches in foreign countries or dependencies or insular possessions of the United States for the furtherance of the foreign commerce of the United States, and to act if required to do so as fiscal agents of the United States.

Second, To invest an amount not exceeding in the aggregate 10 per cent of its paid-in capital stock and surplus in the stock of one or more banks or corportations chartered or incorporated under the laws of the United States or of any state thereof, and principally engaged in international or foreign banking, or banking in a dependency or insular possession of the United States either directly, or through the agency, ownership, or control of local institutions in foreign countries, or in such dependencies or insular possessions.

Such application shall specify the name and capital of the banking association filing it, the powers applied for, and the place or places where the banking operations proposed are to be carried on. The Federal Reserve Board shall have power to approve or to reject such application in whole or in part if for any reason the granting of such application is deemed inexpedient, and shall also have power from time to time to increase or decrease the number of places where such banking operations may be carried on.

Every national banking association operating foreign branches shall be required to furnish information concerning the condition of such branches to the Comptroller of the Currency upon demand, and every member bank investing in the capital stock of banks or corporations described under subparagraph 2 of the first paragraph of this section shall be required to furnish information concerning the condition of such banks or corporations to the Federal Reserve Board upon demand, and the Federal Reserve Board may order special examinations of the said branches, banks, or corporations at such time or times as it may deem best.

Before any national bank shall be permitted to purchase stock in any such corporation, the said corporation shall enter into an agreement or undertaking with the Federal Reserve Board to restrict its operations or conduct its business in such manner or under such limitations and restrictions as the said board may prescribe for the place or places wherein such business is to be conducted. If at any time the Federal Reserve Board shall ascertain that the regulations prescribed by it are not being complied with, said board is hereby authorized and empowered to institute an investigation of the matter, and to send for persons and papers, subpoena witnesses, and administer oaths in order to satisfy itself as to the actual nature of the transactions referred to. Should such investigation result in establishing the failure of the corporation in question, or of the national bank or banks which may be stockholders therein, to comply with regulations laid down by the said Federal Reserve Board, such national banks may be required to dispose of stockholdings in the said corporation upon reasonable notice.

Every such national banking association shall conduct the accounts of such foreign branch independently of the accounts of other foreign branches established by it and of its home office, and shall at the end of each fiscal period transfer to its general ledger the profit or loss accrued at each branch as a separate item.

Any director or other officer, agent, or employee of any member bank may, with the approval of the Federal Reserve Board, be a director or other officer, agent, or employee of any such bank or corporation above mentioned in the capital stock of which such member bank shall have invested as hereinbefore provided, without being subject to the provisions of Sec. 8 of the act approved Oct. 15, 1914, entitled "An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes."

As of the close of 1927, 9 American banks were operating 93 branches or offices outside of the United States while in addition two American

foreign-banking corporations were operating 11 offices, and 3 foreign subsidiaries of American banks were operating 13 offices. The leading institution of this country engaged in the field of foreign-branch banking is the National City Bank of New York. This institution operates directly 69 foreign branches and through subsidiary companies operates 10 branches. The countries served by this bank are shown in the following table:

National City Bank, New York:	
Argentina	2
Belgium	2
Brazil	4
China	8
Cuba	25
Chile	2
Dominican Republic	6
England	2
India	3
Italy	2
Japan	4
Java	1
Panama	2
Peru	1
Porto Rico	2
Singapore	1
Uruguay	1
Venezuela	1
Total	69
National City Bank, Paris: [1]	
France	1
International Banking Corporation, New York: [1]	
China	4
England	1
Philippine Islands	2
Spain	2
Bank Nationale de la Republique de Haiti: [2]	
Haiti	11

Growth of Branch Banking.—The following summary is of value in disclosing growth of branch banking in this country and in analyzing the location and type of the several branch-banking systems:

[1] Subsidiary of National City Bank, New York.

[2] Stock owned by Bank of Haiti, Inc., a subsidiary of National City Bank, New York.

SUMMARY OF BRANCH-BANKING DEVELOPMENTS, 1924–1929 *

Class of bank or branch, etc.	June 30, 1929	June 30, 1928	Feb. 25, 1927	June 30, 1924
Number of banks	25,115	25,950	26,973†	28,996
Number of operating branches:				
Total	818	835	779	714
Member banks, total	354	355	334	299
National	164	169	145	108
State	190	186	189	191
Non-member banks	464	480	445	415
Size of branch systems: Number of banks operating:				
1 branch	443	469	446	376
2 branches	153	150	127	129
3 to 5 branches	130	126	124	
6 to 10 branches	37	35	35	176
Over 10 branches	55	55	47	
Not classified	....	....	....	33 ‡
Location of parent bank: Number in cities having in 1920 a population of 100,000 or more	359	372	353	289
50,000 to 100,000	84	81	65	
25,000 to 50,000	70	66	61	284
Less than 25,000	305	316	300	
Not classified	....	....	....	33 ‡
Character of systems: Number of banks operating:				
Home-city branches only	518	526	476	391
Outside branches only	252	262	261	283
Home-city and outside branches	48	47	42	40
Branches in operation:				
Total	3,440	3,230	2,900	2,293
Of member banks	2,291	2,161	1,950	1,385
National	993	941	390	248
State	1,298	1,220	1,560	1,137
Of non-member banks	1,149	1,069	950	908
Location of branches: Number located:				
In home city of parent bank	2,362	2,214	1,929	1,508
Outside home city	1,078	1,016	971	785
Establishment of branches: Number established:				
De novo as branches	2,329	2,214	1,996	
By purchase of banks	958	853	735	
No report of method	153	163	169	

* Fed. Rev. Bull., p. 766, December, 1929.

† March, 1927.

‡ Mutual savings and private banks.

Reasons for Branch Banking.—The reasons influencing banks to extend their activities through branches or agencies are similar to those hitherto discussed as influencing consolidations. In addition, there is the possibility on the part of the well-managed bank in establishing branches of cutting down or lowering the overhead cost of administering the institution per unit of business, and thereby creating additional profit for its shareholders.

Most of the cities of this country are rapidly growing in population, and more important, the mode of life is being rapidly revolutionized because of the use of the automobile as a means of passenger transportation. The congestion in any of the large American cities has reached the point where business is being driven from the so-called heart of the city to the outlying districts, and one finds a tendency to have rapidly expanding business districts in all the outlying districts. A bank can do one of two things: either be prepared to lose customers, endeavoring to replace them by new customers; or it can develop its territory through the establishment of branches so as to include the rapidly growing business districts in the outlying sections of the city, and thereby retain many, if not all, of its old customers as well as attract a substantial share of new business because of the rapid growth of the newer centers.

The progressive bank will probably take the latter course, and this factor has been conducive to the rapid growth of branch banking in our larger cities.

Undoubtedly the growth in the chain-store movement in all lines of trade in this country will stimulate greater activity in the establishment of branch-banking systems. A branch-banking system can better serve chain-store organizations than can a unit banking system, and if the tendency towards branch and chain-store industries develops as rapidly in the next decade as it has in the past decade, branch banking should also be greatly stimulated.

Additional arguments advanced in favor of branch banking are: (1) Branch banking would make more accessible the banking resources and banking facilities of this country. It would do this by opening up branches in convenient locations, where perhaps, at the present time, it would not pay a unit bank to commence operations. (2) Branch banking would increase the mobility of the banking system of this country. It would do this by quickening the transfer of funds between sections of this country and it would enable the banks to take advantage rapidly of any shift of population or business centers. (3) Branch banking would tend to equalize interest rates, because the develop-

ment of widespread branch banking would enable the banks to distribute more equitably the banking resources of the country. (4) Branch banking would correlate the seasonable demands for funds of the different industries located in the different parts of this country. (5) It is stated by those in favor of branch banking that the increase of capital and surplus of the banks in question would afford a greater measure of protection to the depositors. (6) Branch banking would make available larger sums of credit, so that the rapidly growing industries of this country could finance their needs more readily. Industries today demand, in many cases, lines of credit of millions of dollars, and, unless a bank possesses large resources, it is not in a position to meet the requirements of such industries. (7) Branch banking, according to its proponents, would tend to raise the banking standards of this country, because of the peculiar advantages it possesses for training bankers. A parent institution would usually send out to its several branches as managers the employees who have displayed unusual ability, and therefore it is to be assumed that the branches would be operated by trained bankers. This is not always true of the operation of unit banks, because, in many cases, the officials of a rural bank are chosen from among the stockholders, who do not necessarily possess a knowledge of modern bank methods. In other words, the opportunity is present in branch banking for developing trained bankers familiar with modern banking methods and placing them in positions of responsibility in even the smallest of the branches operated in the rural districts, and thereby giving the community the benefit of efficiently managed banking institutions. This need is evidenced by a consideration of bank failures in the United States.

The list of such failures during the 5 years 1924 to 1928 reached the appalling figure of 3,748.[1] The reasons usually advanced to explain the large number of failures fall under the following heads: (1) inadequate capital; (2) one-industry communities; (3) inefficient management; (4) dishonest directors and employers; (5) non-liquid portfolio due to poor judgment on the part of the management, or to sudden business depressions. It is claimed that branch banking will partially receive these causes of failure, and to the extent that the business conditions placing the banks in a strained position cannot be modified, will, nevertheless, place the bank in a better position to meet them successfully.

Reasons against Branch Banking.—Those opposed to branch banking often take the viewpoint that: (1) Branch banking leads to the con-

[1] Federal Reserve Bulletin, p. 247, April, 1926; p. 392, June, 1928; p. 379, June, 1929.

centration of power in the hands of the great banks with their main offices located in the financial centers of the country with the result that the growth of local communities will be severely handicapped. It is feared that the representatives of the parent institution operating local branches will lack the personal sympathy and knowledge of local conditions, and will be out of touch with special local needs. In answer it might be said that branch managers will be judged by the growth and success of the branch, and such growth will be dependent upon an intimate knowledge and sympathetic appreciation of local needs and conditions. (2) Branch banking does not serve the local community as effectively as a unit bank, because the policies of the local branch will be determined by the managing officials of the bank, who are primarily interested in the work of the head office located in a large city. (3) Another argument used against branch banking is to the effect that branch banking will drain out needed capital from the smaller communities of the nation, sending it to the large financial centers. This will not only seriously retard the growth of the communities served by the branches but also might seriously retard the economic growth of the United States. In view of the fact that the deposits put into the local branches arise from persons living in the community served by the branches, there is no reason why the credit extended by the local branches, based upon these deposits, should not be granted exclusively to local individuals. (4) It is stated that branch banking will produce a money trust or a monopolistic influence in this most important field of credit.

An examination of the arguments for and against branch banking seems to disclose the viewpoint that branch banking in the United States is opposed to the interests of the small banker who is serving the rural communities of the United States. The country banker has not the same opportunity to organize branches, and, therefore, it appears that large branch-banking systems, if created at all, will be created by large city banks, and if widespread branch banking is legalized, these banks will spread out their influence from the cities to the rural districts. The rural banker looks with alarm upon any movement which will tend to absorb his institution and perhaps deprive him of a personal remuneration which he might receive because of his connection with the local unit bank. Nevertheless, this important question should be viewed from the standpoint of the welfare of the community and the country as a whole, and not from the standpoint of any one individual or any comparatively small group of individuals.

If branch banking is all that its proponents claim it to be, and if the aforementioned arguments against branch banking are the only serious

arguments that can be advanced against this development, it would appear that branch banking is a step forward in the evolution of the banking business. In respect to the argument which the opponents of branch banking have raised relating to the creation of a banking monopoly, it may be assured that in this country, where the legal supervision of banking has developed to a high degree, this danger would not be great. Furthermore, the geographic extent of the country would militate against the formation of a nation-wide monopoly. In countries where branch banking has been extensively developed, the result has not been the elimination of competition, but rather the intensification of competition among a fewer number of large institutions.[1] Branch banking would make more difficult the local monopoly of single unit banks in small communities.

Branch banking is one of the most important questions facing the bankers in this country today, and deserves serious and thoughtful attention.

Chain and Group Banking.—The fact has been mentioned before that legislation has checked, in many states, the creation of branch-banking systems.

Another form of banking activity has sprung up which is not, up to the present time, controlled by either state or national laws. *Group banking*, or *chain banking*, as it is sometimes called, is developing in this country at a rapid rate. *Group banking* means the control of a number of individual banking institutions by one institution, corporation, or individual, primarily through stock ownership. Although it might be pointed out that some bankers distinguish between group and chain banking. As illustrative of the distinction made one can quote from the testimony of the Comptroller of Currency, Hon. John W. Pole, before the Committee on Banking and Currency of the House of Representatives.[2] Mr. Pole is being questioned by Mr. Wingo.

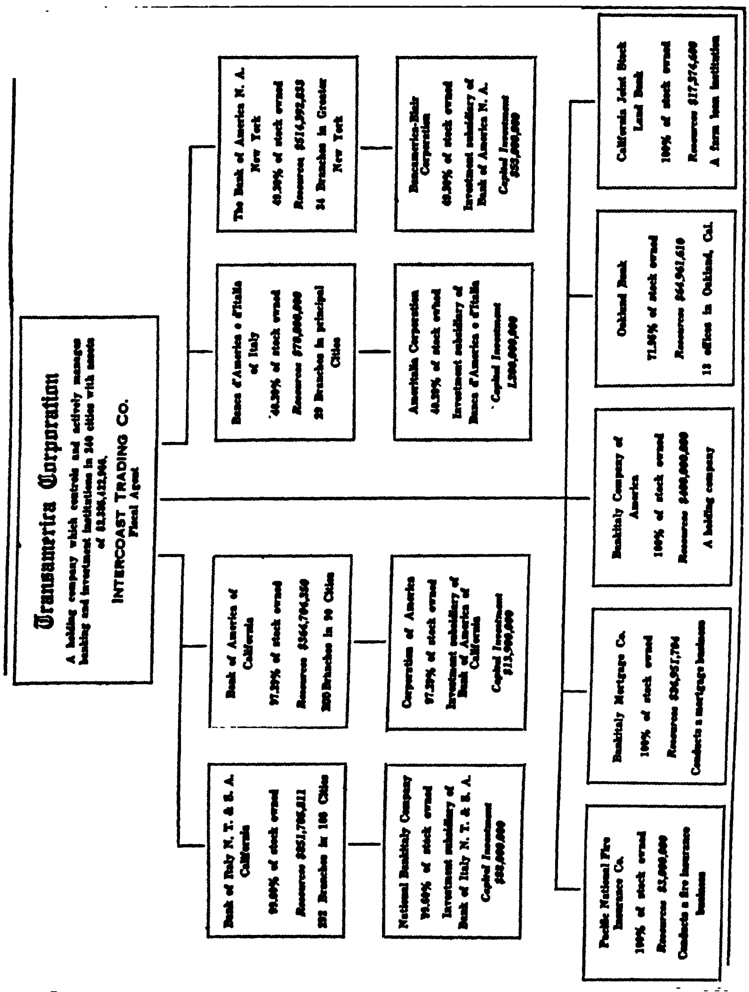
Mr. Wingo: Another thing. Today there is not a very clear conception in my mind—and I think that difficulty may be experienced by some others—of the distinction that you make between group banking and chain banking. Do you, at the moment, recall a distinctive illustration of each that you might use or feel free to use without embarrassment in connection with any individual case?

Mr. Pole: Perfectly so. I would say that in the chain—what we call a chain of banks—there is in the State of Arkansas, as an illustration, a chain of some 55 banks, which, I am informed, are actually controlled by a single individual.

[1] See Harr, L. A., "Branch Banking in England," U. of Pa. Press, 1929.

[2] Hearings before the Committee on Banking and Currency, House of Representatives, 71st Congress, under H. Res. 141, vol. 1, pt. 1, p. 32.

MR. WINGO: Now, you call that a chain. In other words, here are 55 independent banking corporations that have separate local corporate entities and one individual, whom we both have in mind, owns a controlling interest in those 55 separate corporations. You call that a chain?



MR. POLE: Yes, sir.

MR. WINGO: Now, give us an illustration of a group bank, as contradistinguished from the chain.

Mr. Pole: An illustration of the group bank is where a holding corporation is formed and that holding corporation proceeds to purchase independent banks, usually within its trade area, either through an exchange of its stock or for cash and the control of each one of those banks is held through stock ownerships by the corporation.

It appears as if the distinction, if any, between group and chain banking is a very fine one, and probably is not justified.

The diagram of the Transamerica Corporation structure on page 352 is interesting as indicative of the ramifications of a group banking system.

The Marine Midland Corporation, as a further example of group banking, controls the following institutions:[1]

Marine Midland Corporation

Buffalo, New York

Dec. 31, 1929

Banks	Capital, surplus, and profits	Deposits	Resources
Marine Trust Co., Buffalo	$30,253,051	$249,532,825	$305,706,008
Union Trust, Rochester	8,186,799	63,158,678	73,506,772
Manufacturers National Bank, Troy	3,457,767	30,868,193	34,617,789
Power City Bank, Niagara Falls	2,302,771	18,278,223	20,814,965
Niagara Falls Trust Co	2,958,059	14,463,024	17,935,487
Niagara County National Bank and Trust, Lockport	1,441,240	8,934,588	11,303,586
First Trust Co., Tonawanda	1,900,240	9,461,264	11,649,651
Peoples Trust Co., Binghamton	1,349,245	10,072,118	11,671,540
State Trust Co., North Tonawanda	1,405,726	7,431,180	9,186,722
Workers Trust Co., Johnson City	935,588	4,515,307	5,564,521
Lackawanna National, Lackawanna	412,839	4,586,270	5,252,740
Union Trust Co., Jamestown	1,741,442	3,152,252	5,115,906
Bank of East Aurora	299,883	3,008,978	3,552,401
Cortland Trust Co., Cortland	275,936	1,870,522	2,327,058
Orleans County Trust Co., Albion	206,991	923,426	1,237,016
Bank of LaSalle, Niagara Falls	82,780	750,884	864,909
Bank of Snyder	154,042	465,480	649,522
Total (17 banks)	$57,760,358	$431,473,213*	$520,956,593

* Includes $54,488,390 of Marine Midland Corp.

This group, it is expected, will add to its members continually, and only recently acquired an additional bank located in New York City.

[1] *The American Banker*, Feb. 20, 1930.

ROLL CALL OF LEADING BANK GROUPS IN THE UNITED STATES

As of Dec. 31, 1929, in order of deposits

Banks	Number of banks in group	Capital, surplus, and undivided profits	Deposits	Resources	Remarks
Transamerica Corp., San Francisco	3	$216,180,200	$1,537,431,892	$1,891,201,856	The three banks operate a total of 489 branches; 8 small banks also affiliated
Detroit Bankers Co., Detroit	5	89,191,598	581,906,739	711,006,036	Including 15 affiliated banks in Greater Detroit
Manhattan Co., New York	4	97,723,926	510,673,776	729,174,799	Controls two title companies. Resources, $71,354,948
Marine Midland Corp., Buffalo	17	57,760,358	431,473,213	520,956,593	Deposits include $54,488,390 of corporation,
Mellon Group, Pittsburgh	6	102,228,645	419,938,554	549,184,937	Affiliated through directorates; not a group system
Guardian Detroit Union Group	35	66,828,073	393,086,329	509,949,812	
Northwest Bancorporation, Minneapolis	94	44,423,648	385,224,440	454,141,941	Includes Union Investment Co. Group
First Bank Stock Corp., Minneapolis	85	40,993,177	366,272,510	433,074,788	Affiliated corporation resources increase total to $459,373,655
Anglo California Corp., San Francisco	18	28,536,000	211,764,000	277,691,000	
Wisconsin Bankshares Corp., Milwaukee	23	28,265,371	204,019,979	243,312,082	
National Republic Bancorporation, Chicago	8	23,155,500	190,383,849	242,603,344	
Association Banks of Pittsburgh	8	39,805,770	166,255,494	216,463,821	"Hillman Group," Pennsylvania Bankshares and Security Co.
Fourth and First National Group, Nashville	8	23,729,125	110,421,883	174,992,844	
First National Associates, Atlanta	7	19,960,348	110,303,810	136,248,898	
Southwest Corp., Tulsa, Okla. (organizing)	18	....	....	138,000,000	
Commerce Trust Group, Kansas City	5	10,127,245	98,618,140	110,723,431	

Old Colony Associates, Boston	19	16,579,421	94,743,708	116,227,526	Affiliated First National, Old Colony Trust add resources of $731,169,376
Banco Kentucky Corp., Louisville	6	14,696,624	94,606,725	120,710,615	
First Seattle Dexter Horton Group, Seattle	.7	11,267,758	93,029,921	109,978,770	
Citizens and Southern Holding Co., Savannah	7	10,159,543	68,489,950	80,798,122	
Banc Ohio Corp., Columbus	4	10,045,257	67,245,149	79,834,148	Resources of security corporation increase total to $84,379,018
Financial Institutions, Inc., Portland, Me.	10	7,162,000	62,200,000	71,500,000	
First National Group, Portland, Ore.	4	5,390,289	48,861,309	54,795,916	Security Co. resources add $3,845,658
Federal National Affiliates, Boston	8	4,730,146	54,007,998	61,640,635	
First Security Corp., Ogden, Utah	25	5,015,691	45,543,921	51,062,654	Banks in Utah, Idaho, and Wyoming
Marine Bancorporation, Seattle	10	5,631,894	41,809,934	50,815,982	
Hamilton National Association, Chattanooga (organizing)	12	....	....	50,000,000	
Old National Corporation, Spokane	22	3,875,026	37,196,509	43,890,203	
Worcester Company National Affiliates, Worcester, Mass.	6	4,500,000	37,000,000	43,500,000	
Atlantic Trust Co., Jacksonville, Fla.	6	3,808,689	33,938,262	38,436,667	
Fletcher Savings and Trust, Indianapolis	7	3,538,753	26,899,435	31,094,569	Also controls Joint Stock Land Bank resources, $16,710,096
First National Group, Miami, Fla.	6	3,849,499	22,539,545	26,700,848	
First Nebraska Bancorporation (organizing)	..	....	....	25,000,000	
Toy National Group, Sioux City, Ia.	19	2,520,768	21,434,044	24,352,809	
West Coast Bancorporation, Portland, Ore.	9	2,420,145	20,526,431	23,352,951	
American Traders Security Corp., Birmingham, Ga.	3	5,160,860	20,341,024	30,122,847	
Commerce Union Bank Group, Nashville	3	2,095,284	14,895,920	18,976,339	
Pacific Bancorporation, Portland, Ore.	10	1,291,176	11,918,747	13,738,186	
Totals (38 groups)	547	$1,012,648,807	$6,635,003,140	$8,505,255,969	

The extent to which group banking has developed in this country is shown by the table from *The American Banker*, Feb. 20, 1930, appearing on pages 354 and 355.

Other group systems exist throughout the United States than those listed. The tabulation, however, comprises what might be termed the leading *visible* groups, as far as can be determined at this writing, being with few exceptions the groups which are openly committed to group-banking policy or linked through interlocking directorates.

There is a certain danger connected with widespread group banking, because of the lack of supervision over the activities of the group as a whole, although the individual units might be subject to state or national supervision. In other words, a group-banking system places a tremendous power in the hands of the operating institution, corporation or individual, and, in the opinion of some bankers, the creation of such a responsibility places the banking business in a vulnerable position, particularly if control should fall into unscrupulous hands. It seems probable that some form of government control over group banking will be formulated, but it is to be hoped that such regulation will not be along the lines of drastic restriction or prevention of some degree of unified control of large systems. The present Comptroller of the Currency is advocating an extension of the rights of national banks to organize branch systems, and as far as can be observed, the normal evolution of banking in this country seems to be in that direction. It is to be hoped that the question of branch and group banking will be viewed from a dispassionate angle and that the banking legislation of this country will be modified so as to permit the banking business to develop in a manner suitable to meet the many financial problems of the present period, and in a way which will enable the banks to aid American trade and industry most effectively.

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CHAPTER XXVI

BANK EXAMINATIONS

The present bank-examination forces in the United States can be catalogued under six heads:

1. National bank examiners operating under the direction of the Comptroller of the Currency.
2. Examiners operating under the direction of the Federal Reserve authorities, who in turn can be divided into two groups:
    a. Those operating under the jurisdiction of the Federal Reserve banks, who examine member banks within the respective districts, and
    b. Those operating under the jurisdiction of the Federal Reserve Board and who examine the Federal Reserve banks.
3. Examiners operating under the direction of the Federal Farm Loan Board and who examine the accounts of the Federal Farm Land banks.
4. State bank examiners operating under the jurisdiction of the several state departments of banking, who examine those banking institutions chartered by the states, and the trust departments of national banks.
5. Examiners employed by local clearing houses to audit the accounts of the member banks of the clearing houses.
6. Examiners operating under the direction of the board of directors or other administrative officials of the commercial banks. These examiners might be employees of the bank, or professional auditors might be retained to make the examination.

The purposes of bank examinations are to prevent or to discover promptly embezzlements, thefts, or peculations on the part of the employees of the bank; to promote efficiency and prevent carelessness among the members of the banking staff; to inform the officers and directors of the condition of the bank; to ascertain on the part of the examining authorities that the bank is solvent, and is being operated according to law; to advise officers and directors of unsound practices and policies.

In view of the fact that the examinations conducted by those examining the banks are essentially the same, it will not be necessary to go over in detail the examinations made by each one of the six agencies above catalogued. The National Bank Act, as amended by the Federal Reserve Act, states:

Section 21. Sec. 5240, United States Revised Statutes, is amended to read as follows:

The Comptroller of the Currency, with the approval of the Secretary of the Treasury, shall appoint examiners who shall examine every member bank at least twice in each calendar year and oftener if considered necessary: *Provided, however,* That the Federal Reserve Board may authorize examination by the state authorities to be accepted in the case of state banks and trust companies and may at any time direct the holding of a special examination of state banks or trust companies that are stockholders in any Federal Reserve bank. The examiner making the examination of any national bank, or of any other member bank, shall have power to make a thorough examination of all the affairs of the bank, and in doing so he shall have power to administer oaths and to examine any of the officers and agents thereof under oath, and shall make a full and detailed report of the condition of said bank to the Comptroller of the Currency.

The Federal Reserve Board, upon the recommendation of the Comptroller of the Currency, shall fix the salaries of all bank examiners and make report thereof to Congress. The expense of the examinations herein provided for shall be assessed by the Comptroller of the Currency upon the banks examined in proportion to assets or resources held by the banks upon the dates of examination of the various banks.

In addition to the examinations made and conducted by the Comptroller of the Currency, every Federal Reserve bank may, with the approval of the Federal Reserve agent or the Federal Reserve Board, provide for special examination of member banks within its district. The expense of such examinations shall be borne by the bank examined. Such examinations shall be so conducted as to inform the Federal Reserve bank of the condition of its member banks and of the lines of credit which are being extended by them. Every Federal Reserve bank shall at all times furnish to the Federal Reserve Board such information as may be demanded concerning the condition of any member bank within the district of the said Federal Reserve bank.

No bank shall be subject to any visitatorial powers other than such as are authorized by law, or vested in the courts of justice or such as shall be or shall have been exercised or directed by Congress, or by either house thereof or by any committee of Congress or of either house duly authorized.

The Federal Reserve Board shall, at least once each year, order an examination of each Federal Reserve bank, and upon joint application of ten member banks, the Federal Reserve Board shall order a special examination and report of the condition of any Federal Reserve bank.

The national bank examiners operate directly under the jurisdiction of the Comptroller of the Currency, and in order to facilitate their work, 12 chief national bank examiners have been stationed in the 12 cities in which the Federal Reserve banks are located. The chief examiners have immediate charge of the work of their assistants, who actually examine the banks.

The Act states that national banks shall be examined at least twice annually, and this means that the national bank examiners are kept constantly on the move in order to cover the 8,900 odd national banks in existence in the United States.

The Examination.—The essential aims of a bank examination are (1) to appraise the assets and liabilities of a bank, and (2) to secure evidence of the existence and legal custody by the bank of the enumerated assets. Of these two purposes, the first is by far the more important.

The examination, itself, should take place at a time unannounced to the officers and staff of the bank about to be examined. In order to avoid disturbing the daily routine in the bank, the examination of a large bank should be made after the close of business, and not during the period when the staff is busy meeting the needs of the bank's customers. However, in the case of smaller banks, the examination usually starts in the early morning. In many cases the head examiner, with his staff, awaits the opening of the bank, taking custody of all the assets and records necessary for the examination immediately upon opening.

Those assets and records which are not immediately examined are often placed under a seal and initialed by the examiner. This seal is not broken nor are the records released until inspected in the regular course of the examination. Where an early morning examination is made, the examiners immediately count out sufficient cash for the use of the tellers so that the bank's work will not be delayed, and the notes maturing that day are verified and analyzed as rapidly as possible. Bank examiners usually take the attitude that they mean to be of assistance to the examined bank, and therefore try to accomplish their work with a minimum of interference with the daily business operations of the institution.

The bank examiner obtains a sworn statement setting forth the condition of the several departments of the bank, and at the same time a questionnaire requesting information concerning the directors and correspondent bank accounts, etc., is given to one of the officers of the bank to be filled out.

Examiners will start work on the ledgers and on the notes, while the cash items are being verified. The bank examiner is constantly on the alert in watching the actions of the bank employees, in order to see if they seem unduly interested in the examination. In the case of an examination of a state bank by a bank examiner, an officer of the bank stepped up when the former was beginning to count the cash and made the statement that he was going to stay with the examiner. The atti-

tude and appearance of the officer made the examiner suspicious, and he requested that a second officer of the bank be present during the proving of the cash. It developed that there was a shortage of over $1,000,000 in this particular case. Probably, the shortage would have been discovered anyway, even if the officer in question had not displayed undue interest in the work of the examiner; but the fact that he did so tended to put the examiner on his guard. Incidentally, it might be interesting to read what the bank examiner had to say about this particular case:

It was a small bank—about five million total resources. The cashier had been manipulating the accounts for 18 years. This was before the new form report, and 20 examiners were examining 700 banks. This was the first time they had had a morning examination and it was the first time they had had more than one examiner. This cashier had accumulated this shortage in a very clever way over 20 years. He always insisted that any employee should be green; he wouldn't take any from another bank; he wanted to train the employees as he saw fit. The bookkeepers ran the ledgers and turned their controls over to the cashier; then, before making the entries in the general ledger, he would deduct the amount of his shortage, and, of course, the records did not show it up. At the same time he had the amount of the shortage in a dummy ledger concealed in the vault; this was never brought out at the time of the examination. I happened to be new at the work, and asked one of the bookkeepers how many ledgers they had. He said four. We had been informed there were three, so I investigated. The fourth ledger was located, the shortage uncovered, and the bank was immediately closed. I am glad to say, however, that it has now been rehabilitated, and opened up, and the depositors did not lose anything.

In discussing another case, a bank examiner stated:

In checking the notes to the note ledger, I found a number of them were not listed. In the drawer of the note teller, I found more than forty notes, signed in blank by a customer. Of course, this is a very dangerous practice. The cashier may have been dishonest, and could have covered up a shortage by merely filling in such notes. In discussing the matter with the cashier, he wanted to know whether I was casting any reflection on his integrity. The tone of his voice indicated there was something wrong, and there was. Inside of a month, he had committed suicide; inside of two months, the bank was in liquidation.

Cash.—The bulk of the cash items consists ordinarily of checks drawn on other banks in the same community, or on out-of-town banks. Those checks drawn on banks located in the same community are verified by the examiners and sent under seal to the clearing house, in order

to determine whether or not they represent proper charges, etc. Correspondent banks are requested to furnish balances as of the date of the examination, with debits and credits for perhaps three or four days before and after this date. It behooves the examiner to guard against worthless checks and the carrying of debit slips as cash items.

In counting the cash itself, it is not always feasible to go over every bill and every coin. Sample packages of bills are actually counted, therefore, while others might be thumbed over in order to determine whether they are genuine, and also to compare the bulk. Coins can often be weighed, which obviates the necessity for counting.

The total of all outstanding certificates of deposit should be obtained and compared with the account on the general books. Cashiers' checks and certified checks are carefully totaled in order to make certain that they agree with the general books.

Investments.—It is the practice of American banks to invest a substantial proportion of their total resources according to business conditions. During periods of business recession, when the commercial borrowers are few, banks naturally invest more of their resources in bonds, and, in the case of state institutions, in stocks. The bank examiner appraises and verifies securities held in the investment account. It does not matter whether these securities are in the vault of the bank or held by a correspondent bank; they must be appraised. The ideal bond list should contain not only United States government bonds but public utilities, foreign government, municipal and industrial issues, but in such proportion as not to unduly represent any one field of human endeavor. The bank examiner is supposed to make constructive suggestions concerning the investments of the bank as represented in its holdings.

Securities deposited by the customer as collateral for loans made are also carefully examined and appraised. They are listed on a form prepared for the purpose, giving the date of loan, maturity, name of indorsers, sale value, market value, amount loaned, and other salient facts. The purpose of this investigation is to determine whether or not the loan is amply secured. In all cases where securities are released, it is essential that receipts for them be present.

Unsecured Loans.—In so far as commercial banks are concerned, unsecured loans play a very prominent part in the business operations. These occasion an amount of careful study on the part of the bank examiner because he must appraise the loans and he is without the quotations present in the case of stock-exchange collateral. The examiner, therefore, usually insists that a loan in the amount of $5,000 or

more should be accompanied by a recently made-up financial statement, signed by the maker or the indorser. In Pennsylvania, it is the practice to require all such loans, made by a bank with capital and surplus of less than $500,000, and representing more than 1 per cent of the capital and surplus of the bank, to be accompanied by such a statement. The examiner has to take many things into consideration, such as the nature of the business of the borrower, the liquidity of the business as represented by the statement, the net worth of the individual represented, or perhaps the surplus and how it is made up, of the borrower, if it happens to be a corporation. In other words, the statement has to be fairly well analyzed.

A bank examiner states that he has been in banks where they have carried demand notes 18 years without having once called them in. In those cases, this particular examiner has suggested to the banks in question that they request such customers to renew the loan annually, at least.

Where notes representing large amounts are involved, the examiner usually compares the signature thereon with the signature cards in the possession of the bank, as this is where forgery might appear. He is careful to compare the amount of large loans at this examination with the previous reports in order to ascertain whether or not the borrower is making reductions of the loan.

After all the loans are carefully examined, and various items of interest put down on a form, the examiner discusses them with the proper official of the bank. As a result of this discussion, the loans are appraised as good, slow, doubtful, or losses, and the latter immediately written off.

Real-estate Loans.—Real-estate loans are examined to see that they are accompanied by the following papers: a certificate of title; an appraisement giving the value of the land and improvements separately, signed by at least two directors. If the loan exceeds the value of the land, there should be an insurance policy assigned to the bank. All payments made on account of principal should be indorsed on the bond accompanying the mortgage.

The carrying value of the banking house and equipment, itself, should be studied, although as a rule bankers are very conservative and estimate the depreciation on their building at least 2 per cent a year, and their furniture and fixtures on the average of 10 per cent a year.

Deposit Ledgers.—One bank examiner takes the viewpoint that if there is anything wrong with the bank it generally can be found by a close study of the deposit ledgers, as they provide a favorite method of

concealment. Dormant accounts should be carefully examined; large withdrawals in dormant accounts are cause for suspicion. Erasures in the ledgers should be carefully noted, as it might happen that the erasure had been made by someone other than the bookkeeper in charge of the particular ledger. Overdrafts must be taken and compared with overdrafts on the records furnished by the officers of the bank; particularly, overdrafts of officers, directors, and employees of the bank should be thoroughly investigated. The expense account should be examined to see that only legitimate expenses are listed therein.

After the bank examiner has completed his report, it is typed and two copies are made, one going to the bank and the other kept in the files of the banking department making the examination. The report itself should present the unbiased opinion of the examiner concerning the condition of affairs of the bank. The Pennsylvania State Banking Department requests directors of banks to reply in detail to each item of recommendation and criticism made in the bank examiner's report; it does that in order to be more helpful to the bankers themselves.

The office of the Comptroller of the Currency has made the following suggestions to directors of banks in connection with the making of bank examinations.

TREASURY DEPARTMENT
OFFICE OF THE COMPTROLLER OF THE CURRENCY

SUGGESTIONS FOR EXAMINATIONS BY DIRECTORS

In connection with the annual or semi-annual examinations made by examining committees or by accountants at the instance of the board of directors, the following suggestions are made as to the general points that should be covered:

1. The cash should be counted and the total compared with the books of the bank. Cash items should be carefully scrutinized, and any improper items, such as unposted checks held for the purpose of not showing overdrafts, and other items that cannot be readily converted into cash, should be reported.
2. The bonds and other securities of the bank should be examined and those not on hand should be verified by reference to the receipts of the parties with whom they are deposited, and if the receipts are old they should be verified by correspondence. The market value and the amount at which carried on the books in the aggregate should be shown, and any stocks held by the bank should be listed, with a statement showing the reason the securities were taken by the bank.
3. The notes should be carefully checked and their total compared with the general ledger. The genuineness, value, and security of each note, and of any collateral thereto, should be carefully determined, and any losses ascertained, or probable, in the judgment of the committee, should be

noted. The liabilities of each of the larger borrowers, and loans to affiliated interests, should be aggregated and carefully considered. The report should also show the general character of the loans—whether well distributed; the general character of the collaterals; whether corporations in which officers or directors are interested borrow to an undue extent; also any large liabilities of the offices or directors. It should also be shown whether all paper claimed by the bank as its own property, including collaterals, is properly indorsed or assigned to it, and all mortgages recorded. Any loans exceeding 10 per cent of the capital and surplus of the bank should be reported. The signatures of all note makers and indorsers should be carefully scrutinized, and any erasures and alterations or any indications of manipulation should be carefully investigated and reported to the full board. All overdue paper should be listed and comment made as to its collectibility.

4. The certificates of deposit and the cashier's checks should be verified by totaling those outstanding as shown by the register and comparing with the general ledger, and also by comparing the canceled certificates and checks with the register and checking them against the stubs.
5. The copy retained by the bank of the report of condition made to the comptroller at the last call should be compared with the bank's books at that date, particularly with reference to the excessive loans and directors' and officers' liabilities reported.
6. The bank's last reconcilements of accounts with correspondent banks should be compared with the bank's books, and a transcript of the bank's account from the date of the last reconcilement to the date of the examination sent to the correspondent bank with a request for verification. Balances with non-member banks in excess of 10 per cent of the capital and surplus should be reported.
7. Individual ledger balances should be verified in such manner as the directors may deem advisable, by calling in pass books, by sending out reconcilements of certain accounts selected by the directors, or in some other suitable way. A trial balance of the ledger should be taken by some member of the committee, or at least by some person other than the clerk engaged on the ledger.
8. Overdrafts should be totaled and carefully considered, and the report should show any estimated losses.
9. The committee should consider carefully the *Profit and Loss* and the *Expense* accounts, with a view of determining whether the charges against those accounts are proper, whether the earnings of the bank warrant the expense charges, and whether the bank is making a legitimate profit.
10. The examining committee should inquire carefully into the arrangement of the working affairs of the bank and ascertain whether any employee who keeps the individual ledger receives deposits or balances pass books; and whether the employees are properly bonded, and in whose custody the bonds are lodged.
11. Any liability of the bank for borrowed money should be listed, and the proper authority and the necessity for such borrowing ascertained. The total amount of the present liabilities of that nature should be reported to the board, including money borrowed from other banks on certificates of deposit.

The report of the directors or the examining committee should show that these points have been covered, and should recite any deficiencies discovered.

The report should also contain a complete statement of the total assets and liabilities of the bank, with any additions or deductions that in the judgment of the directors should be made as a result of their investigation. There should also be included a detailed statement of the loans which the directors estimate as worthless, doubtful, or insufficiently secured, giving reasons therefor, and as nearly as possible the real value.

A statement should also be made of any matters which in the opinion of the committee affect in any way the bank's solvency, stability, or prosperity.

It is believed that there are few instances where the examining committee cannot, if they will take the necessary time, cover these points fully and satisfactorily.

An examination twice a year, along the lines indicated, by a committee of the directors who will give sufficient time to the work to make it thorough and complete, cannot fail to be of great benefit to all concerned, and this the directors owe to the shareholders who have placed them in their positions of trust.

A complete report of each examination should be preserved in the files of the bank and be accessible to the bank examiner when examining the bank.

COMPTROLLER OF THE CURRENCY

After reviewing briefly the ground covered by a bank examination, one realizes the many qualifications which a bank examiner must possess if he is to perform his work effectively. A bank examiner must not only be trained in the banking business, but he must have a thorough knowledge of accounting; tact is essential; and his personality must be such that he does not irritate the officials of the banks. An error on the part of a bank examiner is unpardonable, and yet, while he must be accurate and thorough, he must also conduct his operations with speed in order not to delay unduly the daily work of the banks.

It is extremely difficult to get first-class bank examiners and to keep them after they have once entered the profession, as a person possessing the qualifications necessary for a successful examiner, such as ability, tact poise, and knowledge of banking and business, will in most cases attract the attention of the bankers and sooner or later will be offered a position with a bank paying perhaps many times the salary received as an examiner. It is this fact that gives great concern to many students of banking, because the success of the banking system in the United States is to some extent dependent upon the quality of the bank examiners.

An examiner's procedure list, as well as forms, showing the assets and liabilities of an institution being examined, and information concerning directors' activities in use by the Banking Department of Pennsylvania are shown on the following pages.

Examiner's Procedure List

Cash items.
Seal:
- Vault cash
- Notes
- Collateral on notes
- Investments
- Trust assets
- Safe-keeping
- Conversion
- Travelers' checks and letters of credit
- Stock certificate book
- Minute book

Cash:
- Banking Department
- Foreign Department
- Trust Department

Deposit tickets in teller's cage:
- Verify large withdrawals included in day's business

Foreign letters.
Clearing house:
- Trace origin of large items
- Check replies
- Return items

Notes:
- Prove
- Check to register
- Liability of officers, directors, and employees

Three-day letters.
Affiliation letters:
- Replies received
- Recapitulation

Ledgers (take possession promptly):
- Individual: large balances
- Savings: public funds
- Christmas: general ledger accounts
- Overdrafts: Liberty bond

Collateral loans:
- List
- Check collateral
- Exceptions
- Price
- Loans to officers and employees of other state banks and trust companies
- Secured by liens on realty
- Distribution

Investments:
- List
- Check
- Brokers' receipts
- If covered in minutes
- Price

Safe-keeping:
- List exceptions

Past due to cash book.
Travelers' checks and letters of credit:
- Letters of verification
- Replies received

Bonds and mortgages owned.
Judgments of record.
Other real estate:
- Deeds and insurance
- When and how acquired

Office building:
- Deeds and insurance: Net return

Take off:
- Treasurer's checks: certified checks
- Dividend checks: certificates of deposit
- Capital stock and ledger

Lines:
- Financial statements: average balances
- Ratings—Dun's–Bradstreet's

Fidelity bonds, etc.
Transcribe statement.
Profit—loss:
- Check: called report
- Earnings and dividend
- Declaration of dividend
- Statement as of examination

Reconcilements:
- Test check of bank's previous reconcilements

Reserve:
- Date of examination: date of dividend
- Pass book (notice for withdrawals)
- Approved reserve agents

Minutes:
- By-laws
- Letters from State Banking Department
- Resolution for borrowing
- Report of examining committee
- Directors' attendance

Employees bonds.
Insurance.
Salary list.
Stockholdings of directors, officers, employees.
Overdrafts of directors, officers, employees.
Answer questions on report.
Rediscounts—time—collateral.
Interest on bank balances.
Interest in arrears.
When interest is paid (Savings: Demand).
Test check interest received.
Check overdrafts: if made good
Inspection of accounts:
  Expense: Interest paid and interest received
  Furniture and fixtures
Trust department: corporate trusts.
Foreign Department.
Safe Deposit Department.

Reference

MILLET, J. I.: "Bank Audits and Examinations."

BANKING DEPARTMENT OF PENNSYLVANIA

Name of Examiner ______________________ No. of Institution ______________

Examiner's report of the condition of

The ______________________ (City) ______________ (County) ______________ (State)

CANCELLED

Examination commenced at __________ o'clock ______ M., on ______________ As of close of business ______________

Examination closed at __________ o'clock ______ M. ______________

______________ President ______________ Cashier Treasurer

Chartered ______________, under Act of ______________ DATE OPENED FOR BUSINESS ______________

The information contained herein is based upon the records and books of the institution and upon statements made to the Examiner by officers and employes of the institution, and on data secured from other sources believed to be reliable and presumed by the Examiner to be correct. Much of the information in regard to the assets of the institution is of such a character as to make it necessary for the Examiner to rely upon the good faith and assurances of his informants, and while the Examiner regards the statements so accepted by him as correct, he is, necessarily, not in a position to guarantee the accuracy of such part of the information as may not have been obtained at first hand.

This report is furnished to the directors and officers for their confidential information, with the understanding it is not to be published either in whole or in part.

Resources	Amount	Liabilities	Amount
1. RESERVE FUND:		1. Capital stock paid in,	
Cash, specie and notes,		2. Surplus fund,	
Due from approved reserve agents,		3. Undivided profits, Less—Expenses, etc.,	
Legal reserve securities, at par,		4. Reserved for depreciation,	
2. Nickels and cents,		5. Reserved for interest, taxes and expenses,	
3. Checks and cash items,		6. DEMAND DEPOSITS:	
4. Due from banks, trust companies, etc., excluding reserve,		Deposits subject to check,	
5. Bills discounted: Upon one name,		Demand certificates of deposit,	
6. Bills discounted: Upon two or more names,		Demand savings fund deposits,	
7. Time loans with collateral,		Commonwealth of Pa.,	
8. Call loans with collateral,		U. S. Postal savings,	
9. Loans secured by bonds and mortgages,		Certified checks,	
9a. Loans secured by judgments of record,		Cashier's or Treasurer's checks,	
10. Loans on call: Upon one name,		7. TIME DEPOSITS:	
11. Loans on call: Upon two or more names,		Time certificates of deposit,	
12. Bonds,		Special time deposits,	
13. Stocks,		Time savings fund deposits,	
14. Bonds and mortgages owned,		8. Due to banks, trust companies, etc., excluding reserve,	
15. Judgments of record owned,		9. Dividends unpaid,	
16. Office building and lot, Furniture and fixtures,		10. Notes and bills re-discounted or guaranteed,	
17. Other real estate,		11. Bills payable on demand,	
18. Overdrafts,		12. Bills payable on time,	
19. Customers' liability on letters of credit and acceptances,		13. Acceptances executed and letters of credit issued,	
20. Book value of legal reserve securities above par,		14. Book value of legal reserve securities below par,	
21. Other assets not included in above,		15. Other liabilities not included in above,	
Total,		Total,	

CANCELLED CANCELLED

Contingent Liabilities

(Include here all contingent liabilities not dealt with elsewhere in this report)

____

____

Total ______________

No. of Institution ________

Directors

Opposite the name of each director enter full amount of paper in institution upon which his name (individual or firm) appears as maker, indorser, or guarantor, but where two or more directors are liable on the same paper, deduct from the total the duplicate liabilities so as to show the net liabilities of all directors.

NOTE—In the column after "Name," give number of directors' meetings attended by each director since last examination. Number of meetings since last examination. (   )

No. of shares owned	Name (List alphabetically)		Post-office address	Liability as payer (individual or firm) including overdrafts	Liability as indorser or guarantor	Occupation
	% of total shares		Total,			
			Add loans to officers not directors			
	By-laws provide for		Gross total,			
	( ) directors		Less duplications,			
	Give number at time of examination ( )		Net total,			

CANCELLED

	Current examination				Previous examination			
Total loans $____ (Items 5 to 11, Resources, Schedule 1)	Non-collateraled	Collateraled	Percentage of total to Capital and surplus	Percentage of total to Loans and discounts	Non-collateraled	Collateraled	Percentage of total to Capital and surplus	Percentage of total to Loans and discounts
Total of direct loans								
To officers and directors ____								
To corporations, etc., in which directors and officers are interested ____								

Information in connection with management and supervision by directors

1. State how often, and when directors meet as a board. 1a. State fee paid each attending director.

2. Do they authorize loans and discounts? 2a. If so, in what manner?

3. In what manner do they approve loans and discounts?

4. Are overdrafts read to the board of directors? 4a. Are demand loans read periodically?

5. Do they have an active discount committee? 5a. Is a record kept of their proceedings?

6. Does the board authorize the purchase of investments? 6a. If so, in what manner?

7. In what manner do they approve the purchase of investments?

8. Do they have an active examining committee? 8a. Give dates of examinations made during period covered by this report.

8b. Is a written report made to the board of directors? 8c. Is report recorded in the minute book?

8d. Does the examination include all asset and liability items? 8e. Does it include the trust department?

CANCELLED

8f. To what extent do officers and employes assist?

9. Do the directors or examining committee approve expense account periodically, and if so, how frequently?

10. Do minutes show consideration of report of last official examination?

11. Are important letters from supervising authority and replies thereto noted in the minutes?

12. Ascertain, if possible, whether any director has become disqualified by hypothecation of stock.

13. Do the by-laws seem to be adequate and satisfactory, and do their provisions seem to be observed by the officers and directors of the bank?

CHAPTER XXVII

THE ORGANIZATION OF THE FEDERAL RESERVE SYSTEM

Banking before and during the Revolutionary Period.—Prior to 1781 there were no incorporated banks in the American colonies. Deposit banking as such was not practiced, and the few private banking institutions operated as investment bankers, and issued paper money which circulated at varying rates of discount. The medium of exchange was chiefly specie of the various foreign powers with English coins predominating in most sections, supplemented, prior to the Revolution, by issues of paper money, printed and put into circulation by certain of the states as well as the bank notes above mentioned. During the Revolution, the Continental Congress issued paper money to finance the costs of the war, and as larger and larger amounts were issued, this paper money fell in value until it ultimately became worthless. The results of the flooding of the country with worthless paper money are vividly portrayed by an American student of banking history.

> . . . The misery and iniquity wrought by the depreciating currency were beyond all description. The rise of prices encouraged the most demoralizing speculation, while the sudden acquisition of unearned and undeserved wealth by rascals and sharpers stimulated the most wanton and shameful extravagance. . . . The paper money opened the door to the most shameful frauds upon all who were so unfortunate as to be in the position of creditors. Dishonest debtors were enabled to pay their debts in worthless currency. Witherspoon wrote, "For two or three years we constantly saw and were informed of creditors running away from their debtors, and the debtors pursuing them in triumph, and paying them without mercy." Guardians of trust funds were enabled to acquit themselves of their obligations by paying widows and orphans in paper that was worth only the smallest fraction of its nominal value.[1]

The first incorporated bank in this country was the Bank of North America, authorized by Congress in 1781 to aid in the financing of the Revolutionary War. Robert Morris was the moving figure in this enterprise, and the bank made short-time loans to the government and discounted the loans of individuals who had claims against the govern-

[1] Bullock, Charles J., "The Monetary History of the United States," p. 68.

ment. Morris himself indorsed many of these notes, thus pledging his personal fortune to the support of government credit. In 1787, this bank obtained a state charter and entered upon a long and successful career. Its success induced in 1784 the incorporation of the Bank of New York and the Bank of Massachusetts.

First Bank of the United States.—The first banking statute of any importance in the United States was passed in 1791 and authorized the establishment of the First Bank of the United States. This bank had a capital of $10,000,000, one-fifth subscribed by the government and four-fifths by the investing public. It was chartered for a period of 20 years, and its main office was in Philadelphia, with eight branches located in Boston, New York, Baltimore, Washington, Norfolk, Charleston, Savannah, and New Orleans.

The bank was organized to perform the following fiscal and banking services: (1) to provide a sound and elastic currency for the United States; (2) to act as depository of government funds; (3) to provide the bullion needed by the mint for coinage purposes; (4) to transfer government funds without serious effect upon the money market; (5) to prevent excessive issue of state bank notes, by putting pressure upon institutions issuing notes forcing them to meet certain requirements if the Bank of the United States was to redeem these notes; and (6) to act as the fiscal agent of the government, which meant primarily that it was to loan funds to the new government.

This bank, for which the credit is usually ascribed to Alexander Hamilton, had a most successful career during the 20 years of its existence. It provided this country with a modern and outstanding banking system. However, in so doing it was necessary to frown upon the reckless banking activities of certain of the state institutions, and sufficient political pressure was brought to bear against the renewal of its charter to force it out of existence in 1811.

Second Bank of the United States.—The period between 1811 and 1816 was marked by considerable financial chaos. The War of 1812 imposed financial burdens upon the government which had to be met without the assistance of a government bank. State banks were organized with great rapidity, their numbers increasing from 88 in 1811 to 246 in 1816, and state bank notes circulated in increasing amounts, expanding from $23,000,000 in 1811 to $100,000,000 in 1816. This increase in the volume of paper money, together with doubts as to the solvency of some of the issuing banks, led to depreciation in the value of the notes, and they circulated at varying rates of discount. The government lost large sums by collecting revenues in depreciated currency

and by the failure of certain state banks in which government funds had been deposited. The chaotic conditions led to a demand for a second United States bank similar to the First Bank of the United States, and in 1816 the Act was passed granting its charter.

This bank had a capital of $35,000,000, and its head office was located in Philadelphia. It performed functions similar to those of the First Bank of the United States, although it was not as ably managed as the First Bank. Unfortunately, however, its charter only ran for 20 years; political opposition again was successful in preventing the renewal of its charter, and in 1836 its passed out of existence.

Independent Treasury System.—Until 1846, the funds of the United States government were deposited in selected banks scattered throughout the country. During the existence of the First Bank of the United States, it acted as the chief government depository, but from 1811 to 1816 the government was forced to deposit its funds with state banks. Following 1816 the Second Bank of the United States was again utilized, but the Secretary of the Treasury was given the power to use other banks at his discretion, and in the last few years of the existence of the Second Bank, a great deal of government money was deposited with certain favored state banks, known as *pet banks*. Following 1836, the state banks were again wholly utilized. Some failed, with consequent loss of government funds, and the system proving unsatisfactory, President Van Buren suggested that the government be the custodian of its own funds. In 1846, the bill creating the Independent Treasury was passed, providing for the custody of United States funds, and in addition that all taxes and duties should be paid in gold, silver, or treasury notes. This specie was kept in the Treasury and in various subtreasuries which were established in certain of the larger cities where most of the government receipts were collected. This system, although successful in safeguarding government funds, had the serious disadvantage of keeping out of circulation excessively large sums of money at various times, and a considerable amount of specie at all times. Government receipts and expenditures were not correlated, so that at times large sums would be taken from the money market, with consequent increase of interest rates and detriment to business; and, at other times, large sums would be paid into the market, causing unduly low interest rates and consequent stimulation to speculation. This unfortunate system continued until the passage of the Federal Reserve Act.

State Banks (1836–1863).—This period has been often spoken of as the era of state banking. A number of states chartered banks modeled

upon the First and Second Banks of the United States, and some of these were successful, but many of them, particularly in the West and South, failed, with serious losses to depositors and the holders of unredeemed notes. In New England, a successful system, under the leadership of the Suffolk Bank of Boston, was developed, and, in New York, beginning in 1829, a safety fund contributed by the banks was built up to pay the losses of failed banks. This latter plan was not very successful until in 1842 the use of the fund was limited to the redemption of the notes of failed banks. In the western and southern states, there was practically no banking regulation, and many banks, called *wild-cat* banks, were organized in remote sections, for the purpose of issuing notes. The isolated location of these banks made their notes difficult to redeem, and tended to keep them in circulation for a longer period of time at high rates of discount. Some were organized with fraudulent intent, most of them were poorly managed and the number of failures was large. This chaotic situation was one of the causes of the passage of the National Bank Act in 1863.

National Banking System.—The National Bank Act was passed during the Civil War, and the condition which led to its passage arose partly out of the war, and partly out of the unregulated banking conditions of the prior state banking era. The country was badly in need of a sound and uniform currency system, which the state banks had failed to provide. To accomplish this, national banks were given permission to issue notes secured by government bonds, and by an Act passed in 1865, state bank notes were legislated out of existence by imposing on them a prohibitive tax of 10 per cent per annum. Under the terms of the original act, all national banks were required to buy government bonds in an amount not less than $30,000 or less than one-third of the paid-in capital stock of the bank. These bonds could then be used as security for a note issue, if the bank so desired. This enforced purchase of government bonds created an artificial demand for them at a time when the war had brought the credit of the government to a low ebb, and bonds were hard to market. The act was therefore a fiscal measure of considerable importance. A third purpose of the act was to provide sound banking institutions over which the Federal government would have supervision and control, and thereby safeguard government deposits. A number of amendments to the act were passed of greater or less importance, but without fundamentally changing its main purposes or structure. The essential parts of the act as they relate to present-day banking practices are discussed at appropriate places in this volume.

Gold Standard Act of 1900.—This act was of national importance, primarily because it settled the silver controversy, and definitely placed this country on a gold-standard basis. It defined the dollar, made the gold dollar the standard unit of value, and provided that all other forms of money should be maintained at a parity with the standard. In addition, it amended the National Bank Act in a number of important respects. Up to this time the minimum permitted capitalization of national banks had been $50,000. This act lowered that minimum to $25,000 in towns with a population of less than 3,000. This opened the way to the establishment of national banks in small communities which heretofore had not had the benefit of their services. The act also permitted the issuance of notes up to the full par or market value of the bonds, whichever was lower, whereas, hitherto, the banks could issue notes up to only 90 per cent of the par value of the bonds. This stimulated an increased issue of national bank notes.

Defects in the Banking System.—The defects of the banking system of the United States prior to the passage of the Federal Reserve Act were obvious and have been discussed by a number of banking writers. From the Civil War to the opening of the World War, our financial history was marked by periodical fluctuations in business activity, culminating in some instances in severe financial panics followed by longer or shorter periods of depression, with resultant unemployment and misery. These disturbances occurred more frequently and were generally of greater severity here than in other large commercial and industrial countries of the world, and it was the consensus of opinion of informed bankers and economists that no small part of the blame for the frequency and extent of these fluctuations could be traced to our banking system.

The need for reform in our banking legislation had long been felt, but the panic of 1907 was the immediate cause of turning public attention to the banking situation. A period of extended prosperity prior to that date had led to overexpansion in business, and a great increase in speculation. The resulting need for capital had been met largely by bank loans which lowered bank reserves to dangerous levels and borrowers could no longer be accommodated. In March, 1907, security prices crashed and in October, 1907, a financial panic was precipitated by the failure of the Knickerbocker Trust Company of New York. Alarm spread to all sections of the country, outside banks and individuals attempted to withdraw funds from New York City banks, the custodians of the bulk of the reserves of the country, and on Oct. 26, the New York banks suspended cash payments, followed by the banks in the rest of the country.

Decentralization.—The banking system in this country was made up of a very large number of independent unit banks doing predominantly a local business, and in times of stress working at cross-purposes. No general uniform policy could be adopted or enforced. There was no single large bank or group of banks responsible for the credit policy of the country. This decentralization meant, further, that the reserves of the banks were widely scattered and could not readily be marshalled to meet a credit deficiency at any point. Each bank maintained a substantial cash reserve in its own vault. It is true that part of the legal reserve was redeposited with other banks, but that simply shifted the responsibility to another bank and further diminished the total reserve, for the bank in which the reserve was deposited loaned out most of it, keeping only a part on reserve so that any serious call for reserves would send the banks tumbling down like a pack of cards. There was no large central bank in possession of the bulk of the reserve money, and capable of marshalling it where necessary. The United States had the largest gold reserve in the world and the most ineffective.

Inelasticity of Credit.—The importance of an elastic credit system has been so often emphasized that it may be taken for granted. Our bank credit, whether note or deposit credit, was peculiarly inelastic. The inelasticity of the national bank note has been discussed. This might not have been a matter of serious moment had our deposit currency been elastic, but it was not, by reason of the rigidity of our reserve requirements and the lack of any available source of new reserve funds. The banks were compelled by law to keep a certain minimum reserve against deposits and they were forbidden to grant loans, if that reserve was below the minimum. During periods of panic, when loans freely extended might allay the public fear, banks could not lend, as their reserves tended to be depleted by withdrawals on the part of depositors who feared for the solvency of the banks. Nor could the banks readily obtain new reserves. Discounting and interbank borrowing were frowned upon and there was no central bank nor open discount market to call upon.

Defective Exchange and Transfer System.—Effective systems of check clearing had been developed in the larger cities through the medium of the clearing houses, but the methods of collecting out-of-town checks were cumbersome. Some banks made collection charges and others did not. Some charged for remitting funds and others did not. To escape these charges, checks were frequently routed from one point to another in roundabout journeys, so that a very large quantity called the *float* would be at all times in the mails, involving con-

siderable economic costs to the community. Meanwhile reserves would be padded by the counting of the funds represented by these checks as money in the possession of the banks sending the checks as well as in the possesion of the banks upon which the checks had been drawn, but which had not as yet received and paid them.

In addition, there was the risk of loss, and the expense of shipment and insurance in the transmission of funds from one part of the country to another in the settlement of debit items.

Lack of a Fiscal Agent for the United States Government.—The funds of the government were kept in the various subtreasuries and in depository national banks. The disadvantages in the loss of interest to the government and in the continual disturbance of the money market, resulting from this deposit of funds in the subtreasuries, have been pointed out. In addition, the practice of depositing government funds in national banks had the disadvantage of causing certain of these banks to rely upon the Secretary of the Treasury for aid in times of financial need, and created a relationship between the Treasury Department and the banks which was unhealthy and open to criticism.

Aldrich-Vreeland Act.—Immediately following the panic of 1907, Congress took steps to remedy the banking situation, and, on May 30, 1908, the Aldrich-Vreeland Act was passed providing for the issuance of emergency currency and creating the National Monetary Commission. The panic of 1907 had again emphasized the fact that we had no system of currency which could be readily and quickly expanded to meet sudden needs. Clearing-house certificates for emergency-currency purposes had been issued to the extent of $255,536,300. To provide for an emergency currency to be issued by the national banks, the act provided that the banks might organize currency associations and issue notes up to 125 per cent of their capital secured by a deposit with the association of state, municipal, and county bonds, accepted at 85 per cent of their market value; miscellaneous securities, including industrial bonds and city warrants, accepted at 75 per cent of their market value; commercial paper, accepted at 75 per cent of the face value; and notes secured by warehouse receipts for cotton, tobacco, etc., accepted at 75 per cent of the face value.

By the time the act was passed, the panic was over, and the currency was not needed, but it was brought into use at the outbreak of the World War. The Federal Reserve Act had, meanwhile, been passed, but the Federal Reserve banks were not organized and opened until Nov. 16, 1914, and their note issue powers could not be utilized at once. Congress, therefore, extended the life of the Aldrich–Vreeland

Act from June 30, 1914, to June 30, 1915, and during that period, $386,444,215 of emergency notes were issued. All were retired by June 30, 1915, to be replaced, as need arose, by Federal Reserve notes.

National Monetary Commission.—More important in its results was the creation by the act of the National Monetary Commission, composed of nine members from the Senate and nine members from the House of Representatives. Its duties were defined in Sec. 18 of the act, which provided:

> That it shall be the duty of this commission to inquire into and report to Congress at the earliest date practicable, what changes are necessary or desirable in the monetary system of the United States or in the laws relating to banking and currency. The commission shall have the power, through subcommittee or otherwise, to examine witnesses and to make such investigations and examinations, in this or other countries, of the subjects committed to their charge as they shall deem necessary.

The commission made a very thorough and exhaustive study of the situation both here and abroad and reported the results of its investigations to Congress the early part of 1912. This report is a classic of banking literature and comprises 23 volumes covering an analysis of the more important banking systems of the world, as well as material dealing with American conditions.

With its report, the commission submitted a draft of a proposed bill to remedy the defects its study had disclosed, but this bill was never brought up in Congress for consideration. Senator Aldrich had previously submitted a plan based on the commission's work, known as the Aldrich Plan, and the substance of it was embodied in the commission's bill.

The political complexion of Congress had changed and the new leaders decided to frame a bill of their own. So in the spring of 1912, the Banking and Currency Committee of the House of Representatives authorized an investigation of currency and banking conditions. A subcommittee under the chairmanship of the Honorable Carter Glass made the survey, and a bill was drawn, and discussed in the committee in the fall of 1912. President-elect Woodrow Wilson was drawn into the discussion and during the early part of 1913 the bill was redrafted and finally submitted to Congress and referred to the Banking and Currency Committee. With some trifling amendments the committee referred it to the House in September, 1913. After considerable debate it passed the House and Senate and was signed by the President on December 23, 1913. Its title stated its purpose in the following words:

An Act to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

There has been much discussion and debate as to what party or group was responsible for the essential provisions of the act. Unquestionably, the framers drew largely upon the work of the National Monetary Commission. H. Parker Willis, the expert of the House Banking and Currency Committee, has stated:[1]

The Federal Reserve Act is the product of a lengthy course of development, and has grown gradually out of the discussion and analysis of the past 20 years. It is not drawn, even largely, from any single source, but is the product of comparisons, selection, and refinement, upon the various materials, ideas, and data, rendered available throughout a long course of study and agitation. Many bills embodying the same general line of thought that now finds expression in the new act have been offered in Congress.

Regional Banks.—The act, as passed, authorized the Organization Committee to designate not less than 8 nor more than 12 cities to be known as Federal Reserve cities, and to divide the continental United States, excluding Alaska, into districts, each district to contain only one of such Federal Reserve cities. The committee decided to establish 12 districts, the full number authorized. After considerable investigation and a number of hearings, the committee selected the 12 Federal Reserve cities. The selection of these cities and the boundaries of the districts were determined, as far as possible, with regard to the convenience of the banks and the customary flow of funds and banking relationships. Likewise, the districts were so arranged that the banking wealth within each district was sufficiently great to insure procuring the minimum capital of $4,000,000 required for each Federal Reserve bank.

The reasons for authorizing a regional system instead of a single central bank were as follows:

a. The geographical extent of the country was so great that there would be administrative difficulties in the operation of a single bank with branches.

b. The various sections of the country differed in business conditions and in prevailing rates of interest, so that a single discount rate enforced by a single bank would be inapplicable to all areas.

c. If a single bank were established, it could hardly be located anywhere but in New York City, the financial metropolis of the country, and there was a strong sentiment in favor or weakening the alleged

[1] *American Economic Review*, Vol. IV, p. 13.

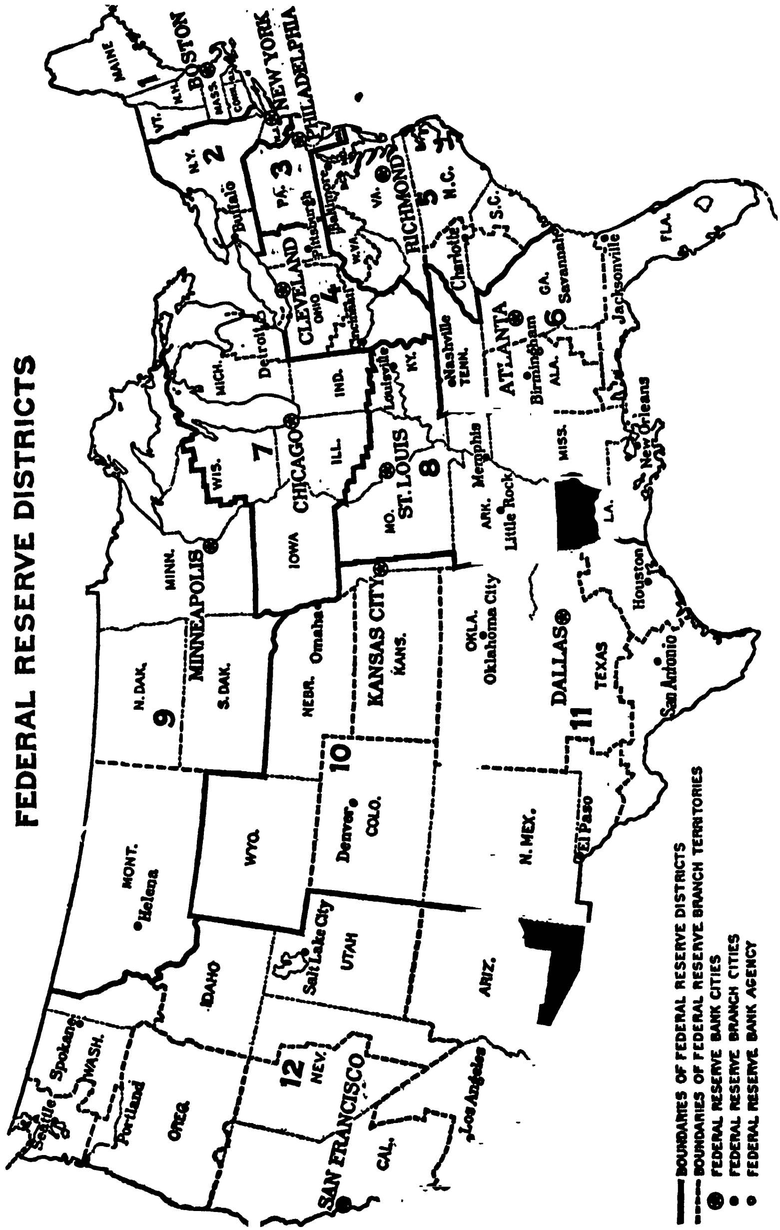
supremacy of New York and its control of the American money market. This sentiment had recently been strengthened by the Pujo Committee's investigation of the co-called *money trust.*

The Federal Reserve Board has the power to readjust the districts by changing the boundaries thereof and in 1915, 1916, and 1920 certain minor changes in districts were made.

Federal Reserve Branches.—The Federal Reserve banks with the permission or upon the requirement of the Federal Reserve Board, may establish branches within their districts, and these branches are operated under the supervision of a board of directors of not more than seven or less than three, of whom a majority is appointed by the Federal Reserve bank of the district and the remainder by the Federal Reserve Board. In addition to the branches, certain of the banks have opened agencies, one in Havana, Cuba. At the present time, branches and agencies are located as follows:

District Number	Federal Reserve City	Federal Reserve Branch Cities	Agencies
1	Boston, Mass.	None	
2	New York, N. Y.	Buffalo, N. Y.	
3	Philadelphia, Pa.	None	
4	Cleveland, Ohio	Pittsburgh, Pa. Cincinnati, Ohio	
5	Richmond, Va.	Baltimore, Md. Charlotte, N. C.	
6	Atlanta, Ga.	Birmingham, Ala. Jacksonville, Fla. New Orleans, La. Nashville, Tenn.	Savannah, Ga. Havana, Cuba
7	Chicago, Ill.	Detroit, Mich.	
8	St. Louis, Mo.	Louisville, Ky. Little Rock, Ark. Memphis, Tenn.	
9	Minneapolis, Minn.	Helena, Mont.	
10	Kansas City, Mo.	Omaha, Neb. Oklahoma City, Okla. Denver, Colo.	
11	Dallas, Tex.	San Antonio, Tex. Houston, Tex. El Paso, Tex.	
12	San Francisco, Calif.	Seattle, Wash. Spokane, Wash. Portland, Ore. Salt Lake City, Utah Los Angeles, Calif.	

Following is a map showing the boundaries of the districts and the location of the branches and agencies.



Membership.—The 12 Federal Reserve banks are owned by the member banks of the district. All national banks are required to be stockholders upon penalty of the forfeiture of their charters, and state banks and trust companies may become members, if they so desire. Member banks are required to subscribe to the capital stock of the Federal Reserve bank of their districts in an amount equal to 6 per cent of their capital and surplus. One-half of the amount subscribed, or 3 per cent of capital and surplus have been called, and is payable upon subscription to the stock in gold or gold certificates. The balance is subject to call by the Federal Reserve Board, but up to the present time no call has been made, nor does it seem likely that any call will will be made, as the Federal Reserve banks have ample capital. As the member banks make changes in their capital or surplus accounts, corresponding changes are made in their stock in the Federal Reserve Bank. Consequently the actual capital of a Federal Reserve bank is not a fixed amount, but one which fluctuates with changes in the capital and surplus amounts of its members.

The original act permitted state banks and trust companies to join the Federal Reserve System, provided that their capital was at least as great as the minimum capital requirements for national banks, and provided that they agreed to conform to the reserve requirements of the act. Practically all states passed legislation permitting state banks to join the system and exempting them from the state reserve requirements after admission. Comparatively few state banks joined the system prior to our entry into the World War in 1917. Thereafter, during the war, considerable pressure was brought upon them to join, for patriotic reasons, and large numbers responded and became members. Since the war, the tendency has set in the other direction and the number of state bank members has declined, largely due to consolidations as well as withdrawals. State banks may withdraw from the system upon 6 months' notice. In practice, this notice is not insisted upon, so that state banks, if they desire, may sever their connection almost at once. In 1923, a provision was incorporated in the Agricultural Credits Act to induce smaller state banks, hitherto ineligible, to become members. At present the bank must either possess the minimum capital required for national banks in the place in which it is located, or possess at least 60 per cent thereof and agree to increase its capital to the required figure within 5 years. To accomplish this, the bank must set aside each year 50 per cent of its net earnings from the preceding year before the payment of dividends, or if the earnings exceed 12 per cent of capital all earnings in excess of 6 per cent must be set

aside, until these accumulated earnings permit of the necessary increase in capital. Very few of the smaller banks have taken advantage of this provision.

Membership of a state bank is subject to the permission of the Federal Reserve Board, and an examination of the bank is made to determine its financial condition, whether its corporate powers are consistent with the purposes of the Federal Reserve Act, whether its business is such as could be legally transacted as a member of the system, and whether the laws of the state under which it is incorporated would be likely to prevent compliance with the provisions of the act and the regulations of the Federal Reserve Board.

The membership in the system, reported by the Federal Reserve Board, as of Nov. 21, 1929, included 1,144 state institutions and 7,472 national banks, a total of 8,616 member banks.

Dividends.—Dividends are paid on Federal Reserve stock at the rate of 6 per cent per annum on the amount paid in, which is the maximum permitted by law. Banks subscribing to stock between dividend periods pay in addition to par, the accrued dividend at the rate of one-half of 1 per cent cent per month, and upon the surrender of stock the same rate of accrued dividends is paid to the date of surrender. This 6 per cent dividend is cumulative.

Double Liability.—Section 2 of the act provides, inter alia:

> The shareholders of every Federal Reserve bank shall be held individually responsible, equally and ratably, and not one for another, for all contracts, debts, and engagements of such banks to the extent of the amount of their subscriptions to such stock at the par value thereof in addition to the amount subscribed, whether such subscriptions have been paid up in whole or in part, under the provisions of this act.

Disposition of Earnings.—After the 6 per cent dividend has been paid (and all back dividends fully met, if any are in arrears) the net earnings of each Federal Reserve bank are paid into the surplus fund until that fund amounts to 100 per cent of the subscribed capital stock of each bank. Thereafter, 10 per cent of the net earnings are paid annually into surplus and the balance is paid to the United States as a franchise tax.

Directors.—The majority of the members of the board of directors of a Federal Reserve bank are chosen by the member banks. The law specifies that the board shall consist of nine members, holding office for 3 years, and divided into three classes designated as classes A, B, and C. The member banks of a particular district are divided into

three groups according to resources, *i.e.*, small banks, medium size banks, and large banks. Each one of the three groups selects two directors, a class A director and a class B director. The class A directors must be bankers, and represent the stockholder banks, while the class B directors must be actively engaged, in the particular district, in commerce, agriculture or some other industrial pursuit. In addition thereto, there are three class C directors, who are designated by the Federal Reserve Board and who represent the Federal Reserve Board on the board of directors of the local Federal Reserve bank. One of these three class C directors is designated as Federal Reserve agent, and by reason of this position acts as chairman of the board of directors of the Federal Reserve bank. The Federal Reserve agent acts as the liaison officer between the board at Washington and the Federal Reserve bank to which he is attached. The directors are elected so that the terms of office of one class A, class B, and class C director expire each year.

The nine members of the Board of Directors of the Federal Reserve bank elect a governor of the bank, who may or may not be a class A or B member of the board of directors. In other words, an outside expert might be designated as Governor of the Federal Reserve bank. The duties of the governor of the Federal Reserve bank are to oversee and direct its activities.

The Federal Reserve Board.—At the head of the Federal Reserve System is the Federal Reserve Board. It supplies the unifying head of the system, and has powers sufficient to enable it to direct and to some extent control credit policy, thus overcoming, in part at least, the defect of decentralization in our banking system. The board has eight members, two, the Secretary of the Treasury and the Comptroller of the Currency, and six appointed by the president by and with the advice and consent of the Senate. Of the six appointed members, not more than one may be selected from any one Federal Reserve district, thus assuring equality of geographic representation, and the president in making his appointment must have due regard to the financial, agricultural, and commercial interests of the country. Originally, the board had only five appointed members, but the Farm Bloc succeeded in procuring an amendment requiring that the agricultural interests be represented by another appointee. The appointed members serve for a term of 10 years, the original five appointees being given terms of 2, 4, 6, 8 and 10 years, respectively, so that in theory one was to be appointed every 2 years, the purpose being to limit the number that any one president could nominate, and prevent any sudden large

change in the board. When the sixth appointed member was added, this arrangement was destroyed, so that now two members may be appointed in 1 year. If the end of their term coincides with the end of the terms of the Secretary of the Treasury and the Comptroller of the Currency, a president may have to appoint four, or half the membership of the board at one time. If members die or resign, the president appoints others to fill the unexpired term.

The Secretary of the Treasury is chairman of the board, but the active executive officer is the governor, assisted by the vice-governor, both designated by the president.

The Federal Advisory Council.—This is a body created to assist the Federal Reserve Board in making decisions concerning the policies to be followed by the system as a whole.

It is composed of 12 members, one from each Federal Reserve district, chosen annually by the boards of directors of the several Federal Reserve banks. This council is supposed to meet at Washington, D. C., at least four times during the course of the year, and oftener, if called by the Federal Reserve Board. The Federal Advisory Council has power, by itself, or through its officers:

> . . . (1) to confer directly with the Federal Reserve Board on general business conditions; (2) to make oral or written representations concerning matters within the jurisdiction of said board; (3) to call for information and to make recommendations in regard to discount rates, rediscount business, note issues, reserve conditions in the various districts, the purchase and sale of gold or securities by reserve banks, open-market operations by said banks, and the general affairs of the reserve banking system.

CHAPTER XXVIII

POWERS OF THE FEDERAL RESERVE BOARD

The specific powers of the Federal Reserve Board are enumerated in Sec. 11 of the Federal Reserve Act. They will be discussed in the order in which they are set forth in the act, with comments thereon. The act empowers it:

2. To examine at its discretion the accounts, books, and affairs of each Federal Reserve bank and of each member bank and to require such statements and reports as it may deem necessary. The said board shall publish once each week a statement showing the condition of each Federal Reserve bank and a consolidated statement for all Federal Reserve banks. Such statements shall show in detail the assets and liabilities of the Federal Reserve banks, single and combined, and shall furnish full information regarding the character of the money held as reserve and the amount, nature and maturities of the paper and other investments owned or held by the Federal Reserve banks.

In the examination of member banks, the Federal Reserve banks cooperate with the national bank examiners and in some cases with the state bank examiners. Examinations of Federal Reserve banks are regularly made by examiners under the jurisdiction of the board.

The Federal Reserve Board requires the 12 Federal Reserve banks to furnish, by wire, at the close of business on Wednesday of each week, a detailed statement showing the condition of the bank, and these statements in turn are released for publication so that they appear in practically every Friday morning's metropolitan daily. The papers publish the statement of condition of the Federal Reserve bank of the district and a consolidated statement showing the condition of all twelve banks. Following is the consolidated statement as published, for three arbitrarily selected dates;

COMBINED RESOURCES AND LIABILITIES OF THE FEDERAL RESERVE BANKS AT THE CLOSE OF BUSINESS

Resources	June 5, 1929	Oct. 5, 1927	Dec. 16, 1925
1. Gold with Federal Reserve Agents	$1,303,555,000	$1,561,864,000	$1,394,759,000
2. Gold Redemption Fund with U. S. Treasury	67,988,000	45,695,000	54,570,000
3. Gold Held Exclusively Against Federal Reserve Notes	$1,371,543,000	$1,607,559,000	$1,449,329,000
4. Gold Settlement Fund with Federal Reserve Board	679,733,000	704,384,000	664,899,000
5. Gold and Gold Certificates Held by Banks	792,692,000	653,841,000	587,358,000
6. Total Gold Reserves	$2,843,968,000	$2,965,784,000	$2,701,586,000
7. Reserves Other than Gold	141,383,000	136,774,000	108,358,000
8. Total Reserves	$2,985,351,000	$3,102,558,000	$2,809,944,000
9. Non-reserve Cash	79,385,000	51,150,000	45,663,000
10. Bills Discounted:			
11. Secured by U. S. Government Obligations	$508,912,000	$242,557,000	$343,121,000
12. Other Bills Discounted	468,532,000	219,928,000	275,946,000
13. Total Bills Discounted	$977,444,000	$462,485,000	$619,067,000
14. Bills Bought in Open Market	112,747,000	262,165,000	352,692,000
15. U. S. Government Securities:			
16. Bonds	48,625,000	255,972,000	73,451,000
17. Treasury Notes	85,295,000	126,624,000	153,740,000
18. Certificates of Indebtedness	13,408,000	122,277,000	171,280,000
19. Total U. S. Government Securities	$147,328,000	$504,873,000	$398,471,000
20. Other Securities (see note)	9,917,000	820,000	3,195,000
21. Foreign Loans on Gold	....	....	8,798,000
22. Total Bills and Securities (see note)	$1,247,436,000	$1,230,343,000	$1,382,223,000
23. Gold Held Abroad			
24. Due from Foreign Banks (see note)	727,000	563,000	710,000
25. Uncollected Items	723,705,000	724,370,000	952,147,000
26. Bank Premises	58,595,000	59,609,000	61,607,000
27. All Other Resources	8,119,000	13,640,000	17,632,000
Total Resources	$5,103,318,000	$5,182,233,000	$5,269,926,000
Liabilities			
28. Federal Reserve Notes in Actual Circulation	$1,647,435,000	$1,717,049,000	$1,788,230,000
29. Deposits:			
30. Member Banks—Reserve Account	$2,321,343,000	$2,360,378,000	$2,264,797,000
31. Government	16,023,000	37,215,000	5,954,000
32. Foreign Banks (see note)	6,744,000	5,382,000	8,398,000
33. Other Deposits	21,668,000	23,352,000	21,356,000
34. Total Deposits	$2,365,778,000	$2,426,327,000	$2,300,505,000
35. Deferred Availability Items	649,782,000	664,038,000	827,072,000
36. Capital Paid In	157,507,000	131,098,000	116,964,000
37. Surplus	254,398,000	228,775,000	217,837,000
38. All Other Liabilities	28,418,000	14,946,000	19,318,000
Total Liabilities	$5,103,318,000	$5,182,233,000	$5,269,926,000
39. Ratio of Total Reserves to Deposit and Federal Reserve Note Liabilities Combined	74.4 per cent	74.9 per cent	68.7 per cent
40. Contingent Liability on Bills Purchased for Foreign Correspondents	$392,415,000	$189,168,000	$50,967,000

NOTE.—Beginning with the statement of Oct. 7, 1925, two new items were added in order to show separately the amount of balances held abroad and amounts due to foreign correspondents. In addition, the caption *All Other Earnings Assets*, previously made up of Federal Intermediate Credit Bank debentures, was changed to *Other Securities*, and the caption, *Total Earning Assets* to *Total Bills and Securities*. The latter item was adopted as a more accurate description of the total of the discounts, acceptance and securities acquired under the provision of Secs. 13 and

14 of the Federal Reserve Act, which, it was stated, are the only items included therein.

Following is a brief explanation of some of the items appearing in the combined statement:

Resources. 1. *Gold with Federal Reserve Agents.*—This represents the gold deposited with the Federal Reserve agents as part collateral for the Federal Reserve notes issued to the Federal Reserve banks by the agents.

2. *Gold Redemption Fund with U. S. Treasury.*—This represents the gold held by the Treasury of the United States, in order to redeem any Federal Reserve notes which may be presented directly to the Treasury Department for redemption. This fund must represent at least 5 per cent of the total amount of Federal Reserve notes in circulation, and is counted as part of the gold reserve which must be maintained against notes.

4. *Gold Settlement Fund with the Federal Reserve Board.*—This represents the gold fund which the Federal Reserve Board deposits with the United States Treasury Department, in trust for the Federal Reserve banks. The purpose of this fund is to facilitate the transfer of funds from one Federal Reserve bank or agent by a system of debits and credits on the books of the fund. The gold in this fund is counted as lawful reserve against the deposits or notes of each bank owning the gold. This system of transfer eliminates cost, risk, and delay in the transfer of funds from one section of the country to another whether for settlement of debits arising out of check collections or for any other reason.

7. *Reserves Other than Gold.*—This includes legal tender notes, silver, and all forms of money other than gold or gold certificates which are designated as legal tender.

9. *Non-reserve Cash.*—This represents national bank notes, subsidiary silver, nickels, and pennies.

10 *and* 11.—*Bills Discounted: Secured by U. S. Government Obligations.*—This item represents loans made to the member banks and secured by government securities. It may consist of either paper of customers of the member banks which the latter have rediscounted, or, as is more common, the promissory notes of the member banks, themselves, with a maturity of 1 to 15 days.

12. *Other Bills Discounted.*—This represents loans to member banks which have been made on collateral eligible for rediscount, other than government securities. Such paper may be notes, drafts, and bills of exchange of customers of the member banks, rediscounted by the member banks, or promissory notes of the member banks with a maturity of from 1 to 15 days, secured by such paper.

14. *Bills Bought in Open Market.*—Legally, Federal Reserve banks have the right to purchase both bank and trade acceptances in the open market, but as a matter of practice they have restricted their purchases to bankers' acceptances, and this item represents such transactions.

15, 16, 17, *and* 18. *U. S. Government Securities: Bonds; Treasury Notes; Certificates of Indebtedness.*—This indicates the amount of government bonds, treasury notes and certificates of indebtedness purchased and held by the Reserve banks.

20. *Other Securities.*—Indicates the other investments held by the banks, which are represented mainly by the Federal Intermediate Credit bank debentures. The Federal Reserve banks may also purchase municipal warrants issued by various municipalities in the United States in anticipation of tax receipts.

21. *Foreign Loans on Gold.*—Through the agency of the New York Federal Reserve Bank, the Federal Reserve System may make loans to central institutions of foreign nations, repayable in gold. The other Federal Reserve banks participate ratably in these loans.

22. *Total Bills and Securities.*—This is the total of the earning assets of the Federal Reserve banks.

23. *Gold Held Abroad.*—At various times some of the Federal Reserve banks have gold in the vaults of foreign central banks with which agency relations have been established.

24. *Due from Foreign Banks.*—This item represents the amount owed to the Federal Reserve banks by foreign central banking institutions, and usually results from deposits made by Federal Reserve banks.

25. *Uncollected Items* is composed of checks and commercial paper in the process of collection through the Federal Reserve clearing system.

26. *Bank Premises* represents the cost less depreciation of the premises owned and occupied by the Federal Reserve banks.

27. *All Other Resources* is a bookkeeping item representing a miscellaneous group of assets, such as furniture and fixtures, deferred charges, interest accrued, etc.

Liabilities.—28. *Federal Reserve Notes in Actual Circulation.*—This item represents Federal Reserve notes which have been issued to the public.

29 *and* 30. *Deposits: Member Banks—Reserve Account.*—This item represents the legal reserves of the member banks on deposit in the Federal Reserve banks.

31. *Deposits: Government.*—This item represents the deposit of government funds with the Federal Reserve banks. These banks are

required to maintain a reserve against government deposits, although member banks are not.

32. *Deposits: Foreign Banks.*—Represents deposits made chiefly by the European central banks. Such deposits, of course, facilitate international trade and exchange and are used for such purposes.

33. *Other Deposits.*—This item consists of deposits made by certain non-member banks which are carried under special arrangements, mainly to facilitate the clearing and collection of checks.

35. *Deferred Availability Items.*—Under the clearing and collection system worked out by the Federal Reserve banks, deferred credit is given for items that are sent in for collection. Such deferred-credit items are called *deferred availability items.*

36. *Capital Paid In.*—This item represents the subscription of the member banks to the capital stock of the Federal Reserve banks, and, therefore, is equal to 3 per cent of the combined capital and surplus of all the member banks in the system.

37. *Surplus.*—Under the act, the Federal Reserve banks pay a 6 per cent dividend on their capital stock, and earnings in excess of this amount can be kept by the Federal Reserve banks in order to build up a surplus fund. When this surplus fund becomes equal to 100 per cent of the subscribed capital, or 200 per cent of the paid-in capital of the Federal Reserve banks, the Federal Reserve banks can only retain 10 per cent of the net earnings; the remaining 90 per cent must be paid in to the United States government as a franchise tax.

38. *All Other Liabilities.*—This item is made up of a number of miscellaneous liabilities, such as reserves for various expenses, taxes, etc.

39. *Ratio of Total to Deposit and Federal Reserve Note Liabilities, Combined.*—This ratio is of importance in indicating the position of the reserves of the system. The most important liabilities of the Federal Reserve banks are: (1) Deposits of member banks, and (2) Federal Reserve notes outstanding; and against both of these liabilities Federal Reserve banks are compelled by law to keep a stipulated minimum reserve. In the case of notes outstanding, this reserve is 40 per cent gold, while the banks must keep 35 per cent gold or legal tender in reserve against the deposits of the member banks and government.

40. *Contingent Liability on Bills Purchased.*—This item represents the amount invested by the Federal Reserve banks for foreign banks, usually in banker's acceptances, when these acceptances carry a contingent obligation of the Federal Reserve banks.

The publication of the combined statement of the 12 Federal Reserve banks is awaited with great interest by the business men and bankers of

this country. Certain items in particular serve as indices of credit conditions and the state of the money market, as well as the loan and investment policies of the Federal Reserve banks.

1. *The Reserve Ratio.*—This ratio is computed by dividing item 8, by the sum of items 28 and 34. It is sometimes supplemented by calculating the ratio of gold to deposits and Federal Reserve note liabilities combined, which is computed by dividing item 6 by the sum of items 28 and 34. The latter ratio is at all times slightly lower than the former as the Federal Reserve banks carry a small quantity of reserves other than gold. The legal minimum of reserves lies somewhere between 35 per cent and 40 per cent of the combined note and deposit liabilities of the system, and these ratios indicate, therefore, the extent of the surplus reserves and surplus gold reserves, respectively, of the system. The ratio is high today in comparison with comparable ratios maintained by most of the foreign central banks, because of the abnormally large quantity of gold that came to this country as a result of conditions arising out of the war. The importance of these ratios today is based not so much on their absolute height, as on changes in them from week to week. Rising ratios indicate that the banking reserves are becoming stronger, and this shows favorable credit conditions. Falling ratios would have the reverse implications. A high ratio shows that the Federal Reserve System has an ample supply of funds which may be loaned to member banks and used by them as a basis of credit extension to their customers. If a falling ratio indicates that the reserves are being depleted, and particularly, if the ratio approaches the legal minimum, it can be assumed that the Federal Reserve Board will take steps to bring about restrictions in the extension of credit.

2. *Total Bills and Securities.*—This shows the quantity of Federal Reserve funds actually being utilized by the member banks and in the money market. When, in successive statements, this total is expanding, it shows that business (or speculation) is on the upgrade and is requiring more funds. Any decline in this total would indicate that business demanded less funds, or that the Federal Reserve authorities were limiting the extension of Federal Reserve credit. A continuously rising total may indicate that a condition of strain is approaching which will result in curtailment of credit by the Federal Reserve banks, and by the member banks who are borrowing heavily from the Federal Reserve, as the high totals show.

This total of bills and securities can be profitably compared with deposit and Federal Reserve note liabilities combined. This latter figure is a rough indicator of the total volume of credit employed by the

customers of member banks. If the proportion of Federal Reserve bank advances to the total volume of credit employed, as indicated by the deposit and note liabilities, is high, it shows that the credit situation is becoming tight, and some curtailment of credit is to be looked for.

Weekly Statements of Member Banks.—In addition to the weekly statement of the Federal Reserve banks, the Federal Reserve Board publishes a combined weekly statement of the condition of some 600 member banks, located in the leading cities. These banks possess over 70 per cent of the total resources of all member banks, and nearly half of the entire banking resources of the nation. A comparison of successive statements, showing trends in banking and credit conditions, is of importance in judging general business conditions, and the trend of business activity and credit conditions.

PRINCIPAL RESOURCES AND LIABILITIES OF ALL WEEKLY REPORTING MEMBER BANKS IN TWELVE FEDERAL RESERVE DISTRICTS

(In millions of dollars)

	As at close of business on		
	May 29, 1929	Oct. 26, 1927	Dec. 9, 1925
1. Loans and Investments—Total	$22,001	$27,084	$19,468
2. Loans—Total	16,202	15,020	14,051
3. On Securities	7,112	6,245	5,615
4. All Other	9,090	8,773	8,435
5. Investments—Total	5,799	6,064	5,417
6. U. S. Government Securities	2,897	2,606	2,493
7. Other Securities	2,902	3,458	2,924
8. Reserve with Federal Reserve Bank	1,617	1,729	1,683
9. Cash in Vault	242	267	313
10. Net Demand Deposits	12,791	13,402	13,154
11. Time Deposits	6,765	6,364	5,342
12. Government Deposits	99	193	38
13. Due from Banks	1,012	1,191	
14. Due to Banks	2,389	3,375	
15. Borrowing from Federal Reserve Bank	680	254	482

It would be helpful, probably, to point out the significance of some items appearing on the foregoing statement. Item 2, Loans—Total, represents the total advances made by the member banks to their customers. This item increases with any increase in business activity,

as it reflects the greater demand for credit due to increased business. When business slackens, business men curtail their borrowings and item 2 would decline. Items 3 and 4 are of value as indicating the basis upon which banks are extending credit. Extensions of credit covered by item 4 represent loans and discounts based upon unsecured promissory notes or paper secured by collateral other than stock-exchange securities. In comparison of statements, if item 3 shows an increase, while item 4 declines, it probably indicates the growing absorption of credit by those engaged in the purchase of stock exchange securities, or that, due to a decline in business activity, the banks are forced to lend more freely on stock exchange collateral in order to keep their funds active. A study of item 5, appearing in the statements, will be helpful in determining whether or not the banks are purchasing investment securities on their own account. They usually purchase more heavily when commercial and industrial activity declines. Thus, under such conditions, items 3 and 5 increase and item 4 declines.

Item 10, Net Demand Deposits, is indicative of the deposits made by the customers of the banks. In a comparison of statements, this item varies with changes in business activity, increasing during periods of rising business and decreasing when business activity is declining.

Item 15 indicates the extent to which the member banks are borrowing from the Federal Reserve banks. It is obvious that member banks will borrow more extensively from the Reserve banks when business is active, and a rising tendency of this item, as disclosed by comparative-statement study, is indicative of increasing business activity.

In order to facilitate the intelligent study of the statements of the reporting member banks, certain ratios, derived by comparing different items in the statement, are utilized.

Ratio of All Other Loans to Total Loans and Investments.—This ratio is arrived at by dividing item 4 by item 1. It indicates the relative amount of the earning assets of the member banks that are presumably utilized in financing commercial transactions as distinguished from those funds utilized in the extension of credit by loan on or purchase of bonds and stocks.

Ratio of Total Loans to Net Demand Deposits.—This ratio is derived by dividing item 2 by item 10. It is useful in determining the trend of business. It rises with an increase in business activity and falls when business slows down.

Ratio of Borrowing from the Federal Reserve Banks to Total Loans and Investments.—This ratio is arrived at by dividing item 15 by item 1. It indicates the extent to which the member banks are borrowing

from the Federal Reserve banks in order to meet the demands of their customers. Member banks will only borrow from the Reserve banks, when they find their resources inadequate to take care of the demands of their customers. This usually occurs only during times of pronounced business activity. When business is dull, member banks do not require additional credit from the Reserve banks.

Ratio of Total Investments to Total Loans and Investments.—This ratio is derived by dividing item 5 by item 1. It indicates the proportion of the total earning assets of the banks invested in long-term securities. This ratio varies inversely with business activity, declining as business increases, and increasing as business slackens. A bank, as a rule, will invest largely in securities when its customers, due to declining business activity, are not borrowing on the basis of short-term commercial paper.

Other Statistical Data.—In addition to the two classes of statements discussed above, the board collects and publishes a vast quantity of other statistical data in respect to business and banking conditions, both in this country and abroad. These are published monthly in the official publication of the board, the *Federal Reserve Bulletin*, which contains a review of business and banking conditions, occasional special articles, the official rulings of the board and opinions of counsel, Federal legislation affecting the banking system, as well as the aforementioned statistical material. The board prepares an annual report, giving the history of its activities and policies for the year, together with complete statistics of the operation of the system.

Interdistrict Rediscounting.—The Federal Reserve Board has power:

> *b.* To permit, or, on the affirmative vote of at least five members of the Reserve Board, to require Federal Reserve banks to rediscount the discounted paper of other Federal Reserve banks at rates of interest to be fixed by the Federal Reserve Board.

Although the 12 regional banks are separate and independent corporations, the board is given this power to require them to assist each other in case of need, so that if the bank of one district finds its reserves running low, it may borrow, by the rediscounting process, from another Federal Reserve bank more abundantly supplied with reserves. Although the country's reserves are held in 12 reservoirs, they are made available to any section in need by this system of interdistrict rediscounting. During the years 1919 and 1920, when inflation was reaching its peak, a considerable volume of such rediscounting between Reserve banks took place. Except for this period, the reserves of each Fed-

eral Reserve bank have been adequate for the needs of its district and little or no interdistrict borrowing has occurred.

Suspend Reserve Requirements.—The Federal Reserve Board has power:

c. To suspend for a period not exceeding 30 days, and from time to time to renew such suspension for periods not exceeding 15 days any reserve requirements specified in this act: *Provided,* That it shall establish a graduated tax upon the amounts by which the reserve requirements of this act may be permitted to fall below the level hereinafter specified: *And provided further,* That when the gold reserve held against Federal Reserve notes falls below 40 per cent, the Federal Reserve Board shall establish a graduated tax of not more than 1 per cent per annum upon such deficiency until the reserves fall to 32½ per cent, and when said reserve falls below 32½ per cent a tax at the rate increasingly of not less than 1½ per cent per annum upon each 2½ per cent or fraction thereof that such reserve falls below 32½ per cent. The tax shall be paid by the the Rese ve bank, but the Reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Federal Reserve Board.

This power has never been exercised. Its existence makes it unlikely that a severe financial panic with suspension of payments by the banking system will occur to paralyze the business activities of the country, as has transpired in the past. If a lack of public confidence in the banking system should lead to extensive withdrawals of cash, thus depleting reserves below the legal requirements, it is within the power of the board to suspend the legal requirements until confidence is reestablished.

Other Powers of the Board.

d. To supervise and regulate through the bureau under the charge of the Comptroller of the Currency the issue and retirement of Federal Reserve notes, and to prescribe rules and regulations under which such notes may be delivered by the comptroller to the Federal Reserve agents applying therefor. A chapter will be devoted to a discussion of Federal Reserve notes.

e. To add to the number of cities classified as Reserve and Central Reserve cities under existing law in which national banking associations are subject to the reserve requirements set forth in Sec. 20 of this act; or to reclassify existing Reserve and central Reserve cities or to terminate their designation as such.

f. To suspend or remove any officer or director of any Federal Reserve bank, the cause of such removal to be forthwith communicated in writing by the Federal Reserve Board to the removed officer or director and to said bank.

g. To require the writing off of doubtful or worthless assets upon the books and balance sheets of Federal Reserve banks.

h. To suspend, for the violation of any of the provisions of this act, the operations of any Federal Reserve bank, to take possession thereof, administer

the same during the period of suspension, and, when deemed advisable, to liquidate or reorganize such bank.

i. To require bonds of Federal Reserve agents, to make regulations for the safeguarding of all collateral, bonds, Federal Reserve notes, money, or property of any kind deposited in the hands of such agents, and said board shall perform the duties, functions, or services specified in this act, and make all rules and regulations necessary to enable said board effectively to perform the same.

j. To exercise general supervision over said Federal Reserve banks.

k. To grant by special permit to national banks applying therefor, when not in contravention of state or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which state banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the state in which the national bank is located.

Whenever the laws of such state authorize or permit the exercise of any or all of the foregoing powers by state banks, trust companies or other corporations which compete with national banks, the granting to and the exercise of such powers by national banks shall not be deemed to be in contravention of state or local law within the meaning of this act. . . .

l. To employ such attorneys, experts, assistants, clerks, or other employees as may be deemed necessary to conduct the business of the board. All salaries and fees shall be fixed in advance by said board and shall be paid in the same manner as the salaries of the members of said board.

In connection with this last power, the board has employed an extensive staff, and organized it into divisions, such as Division of Research and Statistics, Division of Bank Operations, Division of Examination, as well as secretaries, fiscal agent, and a legal staff under the direction of a general counsel.

CHAPTER XXIX

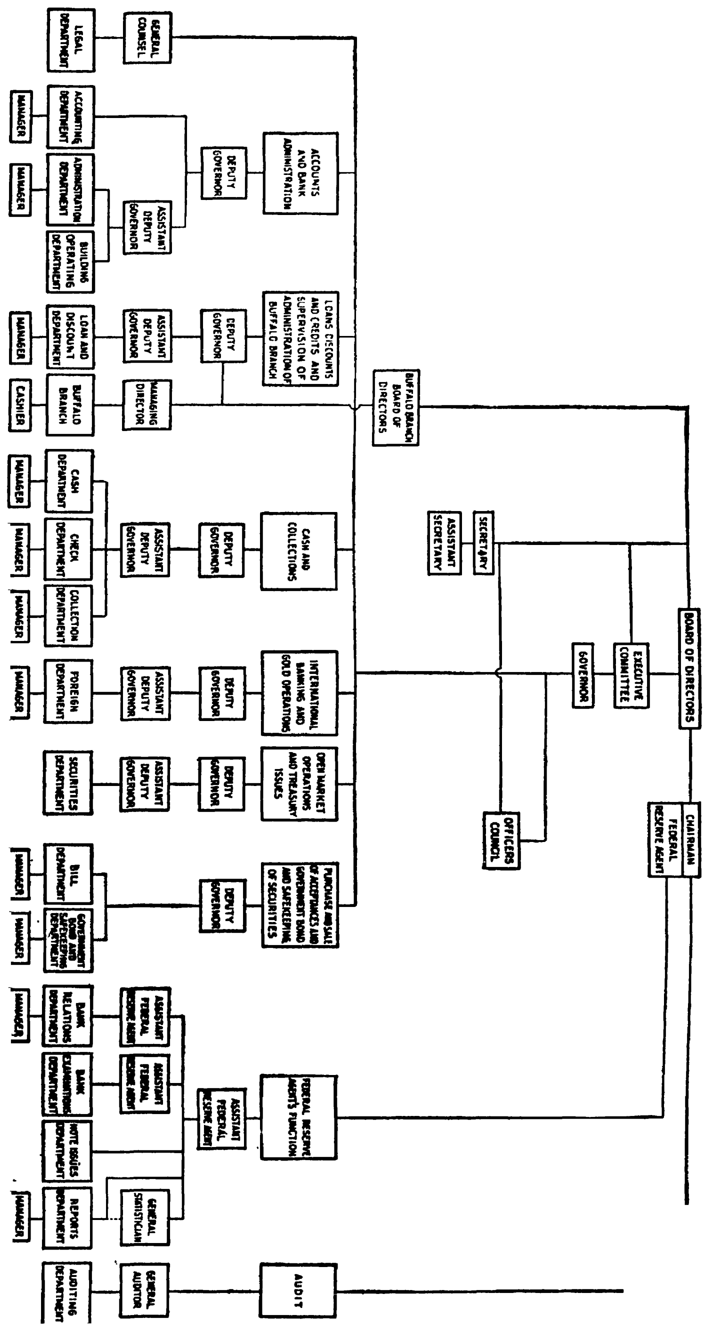
POWERS OF FEDERAL RESERVE BANKS

General Powers.—The Federal Reserve banks are corporate bodies and under the Federal Reserve Act each bank is given the general powers:

1. To adopt and use a corporate seal.
2. To have succession for a period of 20 years from its organization unless it is sooner dissolved by an act of Congress, or unless its franchise becomes forfeited by some viol ation of law. This provision was amended by the Act of Feb. 25, 1927 to read "To have succession after the approval of this act until dissolved by act of Congress or until forfeiture of franchise of violation of law."
3. To make contracts.
4. To sue and be sued, complain and defend, in any court of law or equity.
5. To appoint by its board of directors such officers and employees as are not otherwise provided for in this act, to define their duties, require bonds of them and fix the penalty thereof, and to dismiss at pleasure such officers or employees.
6. To prescribe by its board of directors, by-laws not inconsistent with law, regulating the manner in which its general business may be conducted, and the privileges granted to it by law may be exercised and enjoyed.
7. To exercise by its board of directors, or duly authorized officers or agents, all powers specifically granted by the provisions of this act and such incidental powers as shall be necessary to carry on the business of banking within the iimitations prescribed by this act.

Organization.—In conformity with the powers granted under paragraph 5, above, the banks have organized, created departments and employed officers and other employees. Opposite is a chart showing the form of organization of the Federal Reserve Bank of New York.

Federal Reserve Bank Notes.—For the purpose of enabling national banks to retire their outstanding notes, Sec. 18 of the Federal Reserve Act provided that the Federal Reserve Board might, at its discretion, require the Federal Reserve banks to purchase United States bonds with the circulating privilege from the national banks filing application with the treasurer of the United States to sell for their account such bonds at par and accrued interest. The amounts to be purchased were to be allotted among the Federal Reserve banks and, in the aggregate,


BOARD OF DIRECTORS
CHAIRMAN
FEDERAL RESERVE AGENT
EXECUTIVE COMMITTEE
GOVERNOR
SECRETARY
ASSISTANT SECRETARY
OFFICERS COUNCIL
BUFFALO BRANCH BOARD OF DIRECTORS
GENERAL COUNSEL
LEGAL DEPARTMENT
ACCOUNTS AND BANK ADMINISTRATION
DEPUTY GOVERNOR
ASSISTANT DEPUTY GOVERNOR
ACCOUNTING DEPARTMENT
ADMINISTRATION DEPARTMENT
BUILDING OPERATING DEPARTMENT
MANAGER
LOANS DISCOUNTS AND CREDITS AND SUPERVISION OF ADMINISTRATION OF BUFFALO BRANCH
LOAN AND DISCOUNT DEPARTMENT
MANAGING DIRECTOR
BUFFALO BRANCH
CASHIER
CASH AND COLLECTIONS
CASH DEPARTMENT
CHECK DEPARTMENT
COLLECTION DEPARTMENT
INTERNATIONAL BANKING AND GOLD OPERATIONS
FOREIGN DEPARTMENT
OPEN MARKET OPERATIONS AND TREASURY ISSUES
SECURITIES DEPARTMENT
PURCHASE AND SALE OF ACCEPTANCES AND GOVERNMENT BOND AND SAFEKEEPING OF SECURITIES
BILL DEPARTMENT
GOVERNMENT BOND AND SAFEKEEPING DEPARTMENT
FEDERAL RESERVE AGENT'S FUNCTION
ASSISTANT FEDERAL RESERVE AGENT
BANK RELATIONS DEPARTMENT
BANK EXAMINATIONS DEPARTMENT
NOTE ISSUES DEPARTMENT
GENERAL STATISTICIAN
REPORTS DEPARTMENT
AUDIT
GENERAL AUDITOR
AUDITING DEPARTMENT

could not exceed $25,000,000 in any one year. Against these bonds so purchased, or against the deposit of United States bonds with the circulating privilege, otherwise acquired, the Federal Reserve banks were permitted to issue Federal Reserve bank notes equal in amount to the par value of the bonds so deposited, under the same terms and conditions as related to the issue of notes by national banks, except that the total of the issue of such notes was not limited to the amount of capital stock of such Federal Reserve bank.

Comparatively few Federal Reserve bank notes were issued under the terms of these provisions. During the World War, however, the government, to conserve gold, retired some $350,000,000 of silver certificates, melted the silver dollars and used the silver to settle foreign balances with countries to which silver was acceptable. To replace these silver certificates, which constituted the bulk of the notes of small denominations in circulation, the Pittman Act of Apr. 23, 1918, gave to the Federal Reserve Board authority to permit or require the Federal Reserve banks to issue Federal Reserve bank notes in small denominations in amounts not exceeding the silver dollars withdrawn, upon the security of certificates of indebtedness or 1-year United States gold notes. These issues were temporary in their nature, as they were to be retired as silver dollars were recoined. This retirement began in 1921 and since that date no additions have been made to Federal Reserve bank-note circulation. There were outstanding as of Dec. 31, 1929, $3,413,000 of such notes. They are retired as rapidly as they come into the possession of the bank.

Relations with Member Banks.—*a. Reserves.*—To remedy the defect of scattered reserves under the old banking system, the Federal Reserve Act, as amended June 21, 1917, requires all member banks to keep their entire legal reserve as a deposit with the Federal Reserve bank of their district. This organization of reserves made possible a substantial lowering of the reserve requirements to the present percentages. The member banks are permitted to keep any amount of till money in their vaults that they deem necessary. The method of computing reserves and the penalties for non-compliance with the reserve requirements are discussed elsewhere. Some interesting results of the present reserve requirements should be noted. As a reserve of only 3 per cent is required against time deposits, while a reserve of 7 to 13 per cent, depending upon the location of the member bank, is required against "demand" deposits, many banks have found it profitable to shift their deposits from "demand" to "time" as far as possible. This has stimulated the creation and development of savings

departments in national banks, and led to considerable competition in this field with state banks and saving-fund societies.

No interest is paid on these reserve balances. This is in accordance with sound central banking principles, but it has aroused considerable criticism from certain member banks, particularly when these banks feel it necessary to maintain a considerable quantity of till money and large balances with correspondent banks, for the maintenance of correspondent relationships. Although the reserve requirements under the Federal Reserve Act are lower than most of the state requirements, still, the state laws generally permit till money and correspondent balances to be counted as part of the required reserves, so that such banks may actually maintain under the Federal Reserve System a reserve as large as the state law would require, and lose, at the same time, interest on the balance in the Federal Reserve bank, which would earn interest under the state reserve laws. This has been an important factor in discouraging state bank membership.

Member banks may and do keep on deposit with the Federal Reserve banks sums in excess of the minimum-reserve requirements, and to make up the loss of interest on these accounts, some Federal Reserve banks will invest such surplus balances in bank acceptances, crediting the interest thereon to the member banks, and selling the acceptances when it is necessary to bring the reserve balances up to the required minimum. If the member banks so desire, any other type of commercial paper or securities may be purchased with the surplus balances under similar terms. The Federal Reserve banks will also, at their own expense, transfer these funds by draft or telegraphic transfer from place to place at the request of the member banks.

b. Collection of Checks and Other Items.—The check-clearing and collection services of the Federal Reserve banks have been discussed elsewhere. In addition to the collection of checks, the Federal Reserve banks may collect for members, notes, drafts, coupons, etc., and credit the proceeds to the members' deposit accounts.

c. Rediscounting and Purchase of Paper.—The discounting functions and open-market dealings of the Federal Reserve banks have been made the subject of separate chapters.

d. Supervision of Member Banks. (1) Examinations.—The Federal Reserve Act gives authority to the Federal Reserve banks to examine member banks. This examination in practice takes the form of cooperating with the Comptroller of the Currency in his examination of national banks, and with the state departments of banking in their examinations of state-bank members. Independent examina-

(3) Dollar Exchange.—In addition to the foregoing acceptance powers, member banks may accept drafts, drawn upon them for the purpose of creating dollar exchange, in an amount not exceeding in the aggregate 50 per cent of their capital and surplus. The drafts must be used to promote trade with countries which do not ordinarily have exchange sufficient to meet and pay for seasonal purchases. The board determines the countries whose trade with the United States may be financed in this manner, and the banks to whom permission to accept such drafts is to be given. In making its decisions the board relies upon the recommendations of the Federal Reserve banks which are in touch with the conditions and foreign financing facilities of the member banks.

(4) Interlocking Directorates.—The Clayton Act, in general prohibiting interlocking directorates among banks, nevertheless permits directors to serve, as such, on the boards of two or more banks having assets in excess of $5,000,000 each, if the banks are not in substantial competition with each other, and if the board approves. The decision of the board is necessarily determined by the opinion of the Federal Reserve bank of the district involved.

(5) Fiduciary Powers.—With the permission of the Federal Reserve Board, national banks may undertake trust activities, subject to the supervision of the state banking authorities, and the laws of the state in which the bank is located. Again, the board's decision is governed by the recommendations of the Federal Reserve bank of the district. The bank's recommendation is based on the financial condition and quality of management of the applying bank.

e. Miscellaneous Activities. (1) Advice and Restraint.—The Federal Reserve banks support the member banks in times of need, by means of the rediscounting process. The act has set no limits on the amount of eligible paper that may be rediscounted for member banks, but the Federal Reserve banks must properly conserve their funds and must not be inequitable in dividing the available funds among the member banks. The Reserve banks have in some instances refused to extend further credit to certain member banks, and have exercised some supervision and given advice in respect to member banks' use of funds. In the summer and autumn of 1929, for example, the Federal Reserve banks attempted to discourage the further extension by member banks of loans on stock-market collateral for speculative uses.

(2) Education.—The various Federal Reserve banks have undertaken educational work to acquaint the public and the banks with the functions and work of the Federal Reserve System and the advantages and responsibilities of membership therein. This work has taken various forms, the more prominent being:

(*a*) The publication of monthly reports on business conditions within the district.

(*b*) The preparation and distribution of pamphlets and reports on various topics of interest from time to time.

(*c*) Addresses and articles by officers of the banks explaining the activities of the system.

(*d*) The holding of meetings and discussion groups with officers of member banks.

(*e*) The maintenance of field men who visit member and non-member banks, adjust minor differences, explain the activities of the system, etc.

(*f*) Aid in the installation in member banks of improved systems of accounting and control.

Relations with Non-member Banks. *a. Collections for Non-member Banks.*—Non-member banks may utilize the Federal Reserve clearing and collection system, if they maintain deposit balances with the Federal Reserve bank of their district in an amount sufficiently large to cover items in transit. Only a comparatively few banks have taken advantage of this provision.

b. Collections against Non-member Banks.—The Federal Reserve banks will receive for collection checks on all non-member banks which are on the par list, that is, which have agreed to remit at par funds in payment of checks drawn upon them. In addition to checks, bills, notes, drafts and other time items will be collected and the proceeds credited upon receipt.

c. Purchase of Acceptances and U. S. Securities.—The Federal Reserve banks may purchase, from non-member banks, bankers' accept-

ances, in accordance with regulations passed by the board and trade acceptances of a type eligible for discount. They may also purchase from non-member banks various securities issued by the United States government, as bonds, notes, and certificates of indebtedness. If the Federal Reserve Board declares that the public interest so requires, they may purchase, from non-member banks, acceptances of Federal Intermediate Credit banks and of national agricultural credit corporations, also farm loan bonds and debentures issued by Federal Intermediate Credit banks and national agricultural credit corporations.

Relations with Foreign Banks.—Federal Reserve banks may act as agents of foreign banks and may appoint foreign banks as their agents. This relationship may have to do with the receipt of deposits and paying them out on order, or it may involve the purchase or discounting of bills in this market for the account of foreign banks, or in the foreign market, as the case may be.

Relations with the Public.—The Federal Reserve banks are bankers' banks and in general have no direct relations with the business public. Although the act gives to the banks the authority to purchase acceptances and certain other securities, in practice the banks have refused to deal with individuals and have requested that the application be made through some member bank or acceptance dealer. Likewise, warrants and other securities may be purchased from banks or regular dealers in such securities.

Fiscal Relations with United States.—The service of the Federal Reserve banks as fiscal agents for the United States government include:

a. The Receipt of Government Deposits.—The Secretary of the Treasury may deposit funds of the United States in the Federal Reserve banks, and draw upon such deposits by check. Only a part of the government money is deposited in Federal Reserve banks. Large deposits are maintained in member banks, and in respect to certain funds, as postal savings funds, in non-member banks.

b. The Performance of Certain Functions Hitherto Carried on by the Various Subtreasuries.—By 1920 the activities of the subtreasuries had been transferred to the Federal Reserve banks. These included:

(1) The receipt of gold coin and standard silver dollars for exchange.

(2) The receipt of United States notes, treasury notes, gold and silver certificates, and subsidiary and minor silver coins for redemption.

(3) The exchange of various forms and issues of money.

(4) The cancellation and shipment to Washington of currency unfit for circulation and the laundering of soiled currency which permits of this process.

(5) The receipt from United States depository banks of their surplus deposits of internal revenue, customs, money order, postal, and other government funds.

(6) The receipt of deposits of postal savings funds, post office funds, money order funds, deposits on account of the 5 per cent fund for the redemption of national bank notes, deposits of interest on public deposits, and deposits of funds of government disbursing officers.

(7) The payment of United States coupons.

(8) The payment of checks and warrants drawn against the treasurer of the United States.

(9) The receipt of funds for transfer to other points to Federal Reserve banks or branches located therein.[1]

c. Upon Instructions from the Treasury Department, to Place United States Loans, and Call and Handle the Proceeds of Such Loans.—During the war, this function assumed huge proportions in the handling of the various Liberty Bond issues. At present, it has to do with refunding issues and the short-term government borrowing. Federal Reserve banks now notify member banks and prospective purchasers of the issues and await bids. In case of oversubscription, the banks apportion the issue.

In addition, the banks handle the redemption of securities, exchanges, conversions, transfers of ownership, etc.

Federal Reserve Notes.—One of the defects of our banking and currency system prior to the Federal Reserve Act was the lack of an elastic currency, one which would automatically expand and contract to meet the fluctuating needs of business. This defect was met by authorizing the Federal Reserve banks to issue notes in a manner which would tend to result in elasticity. It was probably the intention of the framers of the act that these notes would gradually replace the other forms of paper currency, with the exception, perhaps, of gold certificates.

Under the provisions of the act as originally passed, these notes were to be secured by 100 per cent of commercial paper. They could be issued only when the Federal Reserve banks were possessed of commercial paper resulting from the rediscount operations. When business was expanding, more paper would be offered for rediscount, and more notes could be issued; conversely, when business was contracting, the commercial paper would decrease in quantity and the notes would be automatically retired. In addition to this security of commercial paper, the Federal Reserve banks were required to keep a reserve of 40 per cent of gold against their outstanding notes, for the purpose of providing for adequate redemption and assuring circulation at a parity with gold.

[1] Annual Report of the Federal Reserve Board (1920).

This theory of note issue was abandoned in practice soon after the banks started operation. The war in Europe and the possible later participation in it by the United States led to a policy of accumulating gold in the vaults of the Federal Reserve banks. The banks and the public wanted new, clean paper money and its type was a matter of indifference, so that in practice the member banks were permitted to exchange other forms of currency and gold for Federal Reserve notes. The Federal Reserve banks were permitted to obtain the notes by depositing gold with the Federal Reserve agents to redeem outstanding notes, recovering the commercial paper held as collateral security and then using the same paper as security for a further issue. Thus a large proportion of the notes became in practical effect gold certificates.

On Sept. 7, 1916, the act was amended to permit acceptances purchased in the open market to be used as collateral for notes, and on June 21, 1917, and Sept. 26, 1918, further amendments were passed, bringing the law to its present status, which is briefly as follows:

Federal Reserve notes may be issued at the discretion of the Federal Reserve Board. They are obligations of the United States and although not legal tender, are receivable by law by all national and member banks and Federal Reserve banks, and for all taxes, customs and other public dues. They are redeemable in gold on demand at the Treasury Department in Washington, or in gold or lawful money at any Federal Reserve bank.

Collateral security equal to 100 per cent of the issue is required, and the collateral may be (*a*) eligible paper discounted by the Federal Reserve banks, including notes of member banks secured by eligible paper or government bonds or certificates; (*b*) acceptances purchased in the open market; (*c*) gold or gold certificates.

A reserve of 40 per cent of gold must be maintained against outstanding notes, but gold or gold certificates held as collateral security by the Federal Reserve agents may be counted as part of this gold reserve. In effect, therefore, the notes may be issued on the security of 40 per cent of gold and 60 per cent of commercial paper or paper secured by United States bonds or certificates; or gold and paper in any proportions provided that at least 40 per cent of gold is maintained as reserve. Substitution of collateral is permitted.

Each Federal Reserve bank must maintain with the Secretary of the Treasury a redemption fund in gold of not less than 5 per cent of the outstanding notes, but such redemption fund is counted as part of the 40 per cent reserve. Gold to the credit of the Federal Reserve banks in the gold settlement fund may be counted as reserve against

either notes or deposits. The notes so issued constitute a first lien on the assets of the issuing bank.

Methods of Issuance.—Federal Reserve banks apply to their local Federal Reserve agents for notes, specifying the amount and denominations required, and tendering the necessary collateral. A large supply of notes, printed in advance, is held by the various agents and at Washington, for issuance to the banks, so that there is no delay in awaiting printing. The Federal Reserve Board passes on the application usually as a matter of form and the notes are delivered to the bank; whereupon it may use them as it uses any other cash.

No Federal Reserve bank is permitted to pay out the notes of any other Federal Reserve bank on penalty of a tax of 10 per cent of the face value of the notes paid out. The denominations authorized are $5, $10, $20, $50, $100, $500, $1,000, $5,000, and $10,000.

Redemption of Notes.—Federal Reserve notes are redeemable at any Federal Reserve bank or at the Treasury Department at Washington. Speedy redemption of some part of the issues is assured by the fact that all notes received by the government in collection of taxes, imposts, and customs are returned at once to the issuing bank for redemption, and all notes received by other Federal Reserve banks are returned either to the issuing bank or to the Treasury Department for redemption. Notes carried by the public are not turned in for redemption, nor are notes in the possession of banks other than Federal Reserve banks, unless they are worn out or unfit for use, or unless the banks accumulate an unnecessarily large quantity of cash.

Security.—From the standpoint of the holder of the notes, they are amply secured. To summarize, their security consists of:

1. At least 100 per cent of negotiable paper or gold
2. The notes are a first lien on the assets of the issuing banks
3. The notes are obligations of the United States
4. As the negotiable paper security is indorsed by member banks, the notes also indirectly constitute a lien on the assets of each indorsing bank to the extent of the paper indorsed.

Elasticity.—It has been seen by the previous discussion, that although the notes may be readily expanded and that provisions have been made for easy and speedy retirement, the automatic aspects of elasticity are lacking. The notes may be issued on the security of gold and to that extent are no more elastic than gold certificates. There is no present observable relation between the fluctuations in the quantity of notes issued and fluctuations in the quantity of commercial paper purchased or rediscounted. These two operations, originally intended

to be complementary, may today move in opposite directions. At the date of writing, Jan. 29, 1930, the banks have outstanding $1,701,901,000 Federal Reserve notes, while the total of bills discounted and purchased in the open market is only $665,413,000. Only part of this paper is deposited as security for notes, so that it is fair to say that at least two-thirds of the present note issue is wholly secured by gold, and these notes are therefore indistinguishable, except in form, from gold certificates.

CHAPTER XXX

FEDERAL RESERVE DISCOUNT PRACTICES

One of the declared purposes of the Federal Reserve System is to afford means of rediscounting commercial paper, and several sections pertaining to this subject are incorporated in the act. However, these sections, in the main, lay down broad, general principles, which shall be defined by the regulations of the Federal Reserve Board. Thus the board issues from time to time rulings, which are intended as interpretations of the broad principles laid down by the act. In the brief space available, it will not be possible to undertake an exhaustive study of member-bank discount but merely to give a cursory viewpoint of the principles and practices of discounting by the Federal Reserve banks.

The discount powers of the Federal Reserve banks are exercised by virtue of Sec. 13 and 13*a* of the Federal Reserve Act. The pertinent provisions are as follows:

Upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice, and protest by such bank as to its own indorsement exclusively, any Federal Reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this act. Nothing in this act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount, and the notes, drafts, and bills of exchange of factors issued as such making advances exclusively to producers of staple agricultural products in their raw state shall be eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the government of the United States. Notes, drafts, and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than 90 days, exclusive of grade.

Upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice, and protest by such bank as to its own indorsement exclusively, and subject to regulations and limitations to be prescribed by the Federal Reserve Board, any Federal Reserve bank may discount or purchase bills of exchange payable at sight or on demand which are drawn to finance the domestic shipment of non-perishable, readily marketable staple agricultural products and are secured by bills of lading or other shipping documents conveying or securing title to such staples: *Provided*, That all such bills of exchange shall be forwarded promptly for collection, and demand for payment shall be made with reasonable promptness after the arrival of such staples at their destination: *Provided further*, That no such bill shall in any event be held by or for the account of a Federal Reserve bank for a period in excess of 90 days. In discounting such bills, Federal Reserve banks may compute the interest to be deducted on the basis of the estimated life of each bill and adjust the discount after payment of such bills to conform to the actual life thereof.

The aggregate of such notes, drafts, and bills bearing the signature or indorsement of any one borrower, whether a person, company, firm, or corporation, rediscounted for any one bank shall at no time exceed 10 per cent of the unimpaired capital and surplus of said bank; but this restriction shall not apply to the discount of bills of exchange drawn in good faith against actually existing values.

Any Federal Reserve bank may discount acceptances of the kinds hereinafter described, which have a maturity at the time of discount of not more than 90 days' sight, exclusive of days of grace, and which are indorsed by at least one member bank: *Provided*, That such acceptances if drawn for an agricultural purpose and secured at the time of acceptance by warehouse receipts or other such documents conveying or securing title covering readily marketable staples may be discounted with a maturity at the time of discount of not more than 6 months' sight, exclusive of days of grace.

Any Federal Reserve bank may make advances to its member banks on their promissory notes for a period not exceeding 15 days at rates to be established by such Federal Reserve banks, subject to the review and determination of the Federal Reserve Board, provided such promissory notes are secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal Reserve banks under the provisions of this act, or by the deposit or pledge of bonds or notes of the United States.

Upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice, and protest by such bank as to its own indorsement exclusively, any Federal Reserve bank may, subject to regulations and limitations to be prescribed by the Federal Reserve Board, discount notes, drafts, and bills of exchange issued or drawn for an agricultural purpose, or based upon livestock, and having a maturity, at the time of discount, exclusive of days of grace, not exceeding 9 months, and such notes, drafts, and bills of exchange may be offered as collateral security for the issuance of Federal Reserve notes under the provisions of Sec. 16 of this act: *Provided*, That notes, drafts,

and bills of exchange with maturities in excess of 6 months shall not be eligible as a basis for the issuance of Federal Reserve notes unless secured by warehouse receipts or other such negotiable documents conveying or securing title to readily marketable staple agricultural products or by chattel mortgage upon livestock which is being fattened for market.

That any Federal Reserve bank may, subject to regulations and limitations to be prescribed by the Federal Reserve Board, rediscount such notes, drafts, and bills for any Federal Intermediate Credit bank, except that no Federal Reserve bank shall rediscount for a Federal Intermediate Credit bank any such note or obligation which bears the indorsement of a non-member state bank or trust company which is eligible for membership in the Federal Reserve System, in accordance with Sec. 9 of this act.

Notes, drafts, bills of exchange or acceptances issued or drawn by cooperative marketing associations composed of producers of agricultural products shall be deemed to have been issued or drawn for an agricultural purpose, within the meaning of this section, if the proceeds thereof have been or are to be advanced by such association to any members thereof for an agricultural purpose, or have been or are to be used by such association in making payments to any members thereof on account of agricultural products delivered by such members to the association, or if such proceeds have been or are to be used by such association to meet expenditures incurred or to be incurred by the association in connection with the grading, processing, packing, preparation for market, or marketing of any agricultural product handled by such association for any of its members: *Provided*, That the express enumeration in this paragraph of certain classes of paper of cooperative marketing associations as eligible for rediscount shall not be construed as rendering ineligible any other class of paper of such associations which is now eligible for rediscount.

The Federal Reserve Board may, by regulation, limit to a percentage of the assets of a Federal Reserve bank the amount of notes, drafts, acceptances, or bills having a maturity in excess of 3 months but not exceeding 6 months, exclusive of days of grace, which may be discounted by such bank, and the amount of notes, drafts, bills, or acceptances having a maturity in excess of 6 months, but not exceeding 9 months, which may be rediscounted by such bank.

The terms *discount* and *rediscount* are frequently used interchangeably. Technically, the Federal Reserve banks rediscount paper when they discount for member banks commercial paper which the member banks have previously discounted for their customers. But the act itself refers to this process as discounting, and the term discount policy is more commonly used than rediscount policy. The provisions of the act will be analyzed and briefly discussed.

Waiver of Demand, Notice and Protest.—The member banks offering commercial paper of their customers for discount must indorse the paper, and their indorsement constitutes on their part a waiver of

demand, notice, and protest. Under the general law governing negotiable instruments, indorsers are relieved of liability if demand for payment thereof is not made on the party primarily liable at the proper time and place, and if they do not receive due notice of default. These rights are given up by the member banks discounting paper, so that if the Federal Reserve banks fail to make demand for payment of the matured paper, or fail to notify the member banks of default, nevertheless, although other indorsers may be released from liability, the member banks are still liable to the Federal Reserve banks for the payment of the paper. Protest by the Federal Reserve banks is not necessary to hold the member banks liable as indorsers. In practice, the Federal Reserve banks return the paper to the member banks for collection a short time before maturity.

Maturity.—The provisions of the act limiting the rediscount of paper in respect to maturities have reference to the time the paper has to run from the date when it is offered to the Federal Reserve bank for rediscount to maturity, and not to the original tenor of the paper.

Regulations of the Federal Reserve Board.—The provisions of the act have been interpreted and applied by regulations of the board. The last series issued was in 1928 and those regulations having reference to discounting are as follows:

REGULATION A, SERIES OF 1928

Discounts under Sections 13 and 13a

ARTICLE A. NOTES, DRAFTS, AND BILLS OF EXCHANGE

Sec. I. General Statutory Provisions.—Any Federal Reserve bank may discount for any of its member banks any note, draft, or bill of exchange: *Provided,*

a. It has a definite maturity at the time of discount of not more than 90 days, exclusive of days of grace; except that (1) if drawn or issued for an agricultural purpose or based on livestock, it may have a maturity at the time of discount of not more than 9 months, exclusive of days of grace, and (2) certain bills of exchange payable at sight or on demand are eligible even though they have no definite maturity.

b. It has been issued or drawn for an agricultural, industrial, or commercial purpose, or the proceeds have been used or are to be used for such a purpose, or it is a note, draft, or bill of exchange of a factor issued as such making advances exclusively to producers of staple agricultural products in their raw state;

c. It was not issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the government of the United States;

d. The aggregate of notes, drafts, and bills bearing the signature or indorsement of any one borrower, whether a person, company, firm, or corporation, discounted for any one member bank, whether state or national, shall at no time exceed 10 per

cent of the unimpaired capital and surplus of such bank; but this restriction shall not apply to the discount of bills of exchange drawn in good faith against actually existing values;

e. It is indorsed by a member bank; and

f. It conforms to all applicable provisions of this regulation.

No Federal Reserve bank may discount for any member state bank or trust company any of the notes, drafts, or bills of exchange of any one borrower who is liable for borrowed money to such state bank or trust company in an amount greater than that which could be borrowed lawfully from such state bank or trust company were it a national banking association.

Any Federal Reserve bank may make advances to its member banks on their promissory notes for a period not exceeding 15 days, provided that they are secured by notes, drafts, bills of exchange, or bankers' acceptances which are eligible for discount or for purchase by Federal Reserve banks, or by the deposit or pledge of bonds or notes of the United States.

Sec. II. General Character of Notes, Drafts, and Bills of Exchange Eligible.—The Federal Reserve Board, exercising its statutory right to define the character of a note, draft, or bill of exchange eligible for discount at a Federal Reserve bank, has determined that:

a. It must be a negotiable note, draft, or bill of exchange which has been issued or drawn, or the proceeds of which have been used or are to be used in the first instance, in producing, purchasing, carrying, or marketing goods [1] in one or more of the steps of the process of production, manufacture, or distribution, or for the purpose of carrying or trading in bonds or notes of the United States, and the name or a party to such transaction must appear upon it as maker, drawer, acceptor, or indorser.

b. It must not be a note, draft, or bill of exchange the proceeds of which have been or are to be advanced or loaned to some other borrower, except as to paper described below under Secs. VI*b* and VIII.

c. It must not be a note, draft, or bill of exchange the proceeds of which have been used or are to be used for permanent or fixed investments of any kind, such as land, buildings, or machinery, or for any other capital purpose.

d. It must not be a note, draft, or bill of exchange the proceeds of which have been used or are to be used for investments of a purely speculative character.

e. It may be secured by the pledge of goods or collateral of any nature, including paper which is ineligible for discount, provided it (the note, draft, or bill of exchange) is otherwise eligible.

Sec. III. Applications for Discount.—Every application for the discount of notes, drafts, or bills of exchange must contain a certificate of the member bank, in form to be prescribed by the Federal Reserve bank, that

1. To the best of its knowledge and belief, such notes, drafts, or bills of exchange have been issued or drawn, or the proceeds thereof have been or are to be used, for such a purpose as to render them eligible for discount under the terms of this regulation; and

2. That such notes, drafts, or bills of exchange have not been acquired from a non-member bank, or, if so acquired, that the applying member bank has received permission from the Federal Reserve Board to discount, with the Federal Reserve bank, paper acquired from non-member banks.

[1] When used in this regulation the word "goods" shall be construed to include goods, wares, merchandise, or agricultural products, including livestock.

In the case of a member state bank or trust company, every such application must contain a certificate or guaranty to the effect that the borrower is not liable, and will not be permitted to become liable during the time his paper is held by the Federal Reserve bank, to such bank or trust company for borrowed money in an amount greater than that which could be borrowed lawfully from such state bank or trust company were it a national banking association.

Sec. IV. Promissory Notes.—A recent financial statement of the borrower must be on file with the member bank if it has discounted the note for a non-depositor or a non-member bank, and in all other cases unless—1. It is secured by a warehouse, terminal, or other similar receipt covering goods in storage, by a valid prior lien on livestock which is being marketed or fattened for market, or by bonds or notes of the United States; or

2. The aggregate of obligations of the borrower discounted and offered for discount at the Federal Reserve bank by the member bank is less than a sum equal to 10 per cent of the paid-in capital of the member bank and is less than $5,000.

Sec. V. Drafts, Bills of Exchange, and Trade Acceptances.—*a. Definition.*—A draft or bill of exchange, within the meaning of this regulation, is defined as an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay in the United States, at a fixed or determinable future time, a sum certain in dollars to the order of a specified person; and a trade acceptance is defined as a draft or bill of exchange, drawn by the seller on the purchaser of goods sold,[1] and accepted by such purchaser.

b. Evidence of Eligibility and Requirement of Statements.—A Federal Reserve bank shall take such steps as it deems necessary to satisfy itself as to the eligibility of the draft, bills, or trade acceptance offered for discount and may require a recent financial statement of one or more parties to the instrument. The draft, bill, or trade acceptance should be drawn so as to evidence the character of the underlying transaction, but if it is not so drawn, evidence of eligibility may consist of a stamp or certificate affixed by the acceptor or drawer in a form satisfactory to the Federal Reserve bank.

Sec. VI. Agricultural Paper.—*a. Definition.*—Agricultural paper, within the meaning of this regulation, is defined as a negotiable note, draft, or bill of exchange issued or drawn or the proceeds of which have been or are to be used, for agricultural purposes, including the production of agricultural products, the marketing of agricultural products by the growers thereof, or the carrying of agricultural products by the growers thereof pending orderly marketing, and the breeding, raising, fattening, or marketing of livestock, and which has a maturity at the time of discount of not more than 9 months, exclusive of days of grace.

b. Paper of Cooperative Marketing Associations.—Under the express terms of Sec. 13*a*, notes, drafts, bills of exchange, or acceptances issued or drawn by cooperative marketing associations composed of producers of agricultural products are deemed to have been issued or drawn for an agricultural purpose, if the proceeds thereof have been or are to be

(1) Advanced by such association to any members thereof for an agricultural purpose; or

[1] A consignment of goods or a conditional sale of goods cannot be considered "goods sold" within the meaning of this clause. The purchase price of goods plus the cost of labor in effecting their installation may be included in the amount for which the trade acceptance is drawn.

(2) Used by such association in making payments to any members thereof on account of agricultural products delivered by such members to the association; or

(3) Used by such association to meet expenditures incurred or to be incurred by the association in connection with the grading, processing, packing, preparation for market, or marketing of any agricultural product handled by such association for any of its members.

These are not the only classes of paper of such associations which are eligible for discount, however, and any other paper of such associations which complies with the applicable requirements of this regulation may be discounted on the same terms and conditions as the paper of any other person or corporation.

Paper of cooperative marketing associations the proceeds of which have been or are to be used (1) to defray the expenses of organizing such associations, or (2) for the acquisition of warehouses, for the purchase or improvement, of real estate, or for any other permanent or fixed investment of any kind, are not eligible for discount, even though such warehouses or other property are to be used exclusively in connection with the ordinary operations of the association.

c. *Eligibility.*—To be eligible for discount, agricultural paper, whether a note, draft, bill of exchange, or trade acceptance, must comply with the respective sections of this regulation which would apply to it if its maturity were 90 days or less.

d. *Discounts for Federal Intermediate Credit Banks.*—Any Federal Reserve bank may discount agricultural paper for any Federal Intermediate Credit bank; but no Federal Reserve bank shall discount for any Federal Intermediate Credit bank any such paper which bears the indorsement of any non-member state bank or trust company which is eligible for membership in the Federal Reserve System under the terms of Sec. 9 of the Federal Reserve Act as amended. In discounting such paper, each Federal Reserve bank shall give preference to the demands of its own member banks and shall have due regard to the probable future needs of its own member banks; and no Federal Reserve bank shall discount paper for any Federal Intermediate Credit bank when its own reserves amount to less than 50 per cent of its own aggregate liabilities for deposits and Federal Reserve notes in actual circulation. The aggregate amount of paper discounted by all Federal Reserve banks for any one Federal Intermediate Credit bank shall at no time exceed an amount equal to the paid-up and unimpaired capital and surplus of such Federal Intermediate Credit bank.

e. *Limitations.*—The Federal Reserve Board prescribes no limitation on the aggregate amount of notes, drafts, bills of exchange, and acceptances with maturities in excess of 3 months but not exceeding 6 months, exclusive of days of grace, which may be discounted by any Federal Reserve bank; but the aggregate amount of notes, drafts, bills of exchange, and acceptances with maturities in excess of 6 months, but not exceeding 9 months, which may be discounted by any Federal Reserve bank shall not exceed 10 per cent of its total assets.

Sec. VII. Sight Drafts Secured by Bills of Lading.—A Federal Reserve bank may discount for any of its member banks bills of exchange payable at sight or on demand which

a. Are drawn to finance the domestic shipment of non-perishable, readily marketable, staple agricultural products; and

b. Are secured by bills of lading or other shipping documents conveying or securing title to such staples.

All such bills of exchange shall be forwarded promptly for collection, and demand

for payment shall be made promptly, unless the drawer instructs that they be held until arrival of car, in which event they must be presented for payment within a reasonable time after notice of arrival of such staples at their destination has been received. In no event shall any such bill be held by or for the account of a Federal Reserve bank for a period in excess of 90 days.

In discounting such bills, Federal Reserve banks may compute the interest to be deducted on the basis of the estimated life of each bill and adjust the amount thus deducted after payment of such bills to conform to the actual life thereof.

Sec. VIII. Factors' Paper.—Notes, drafts, and bills of exchange of factors issued as such for the purpose of making advances exclusively to producers of staple agricultural products in their raw state are eligible for discount with maturities not in excess of 90 days, exclusive of days of grace, irrespective of the requirements of Secs. II*a* and II*b*.

Sec. IX. Paper Acquired from Non-member Ranks.—*a*. Except with the permission of the Federal Reserve Board; no Federal Reserve bank shall discount any paper acquired by a member bank from a non-member bank or bearing the signature or indorsement of a non-member bank; except that Federal Reserve banks may discount bankers' acceptance and other eligible paper bearing the signature or indorsement of a non-member bank, if such paper was bought by the offering bank in good faith on the open market from some party other than the non-member bank.

b. Applications for permission to rediscount paper acquired from non-member banks shall be made in writing by the member banks which desire to offer such paper for rediscount and shall state fully the facts which gave rise to each application and the reasons why the applying member banks feel justified in seeking such permission. Such applications shall be addressed to the Federal Reserve Board, but shall be filed with the Federal Reserve agent, who shall forward them promptly to the Federal Reserve Board with his recommendations.

c. The Federal Reserve Board hereby grants its permission for Federal Reserve banks to discount for member banks paper bearing the signature or indorsement of Federal Intermediate Credit banks, if such paper is otherwise eligible under the law and this regulation.

Article B. Bankers' Acceptances [1]

Sec. X. Definition.—A banker's acceptance within the meaning of this regulation is defined as a draft or bill of exchange, whether payable in the United States or abroad and whether payable in dollars or some other money, of which the acceptor is a bank or trust company, or a firm, person, company, or corporation engaged generally in the business of granting bankers' acceptance credits.

Sec. XI. Eligibility.—A Federal Reserve bank may discount any such bill bearing the indorsement of a member bank and having a maturity at the time of discount not greater than that prescribed by Sec. XII*a*, which has been drawn under a credit opened for the purpose of conducting or settling accounts resulting from a transaction or transactions involving any one of the following:

1. The shipment of goods between the United States and any foreign country, or between the United States and any of its dependencies or insular possessions, or

[1] For regulations governing the acceptance by member banks of drafts and bills of exchange drawn on them, see Regulation C.

between foreign countries, or between dependencies or insular possessions and foreign countries;

2. The shipment of goods within the United States, provided shipping documents conveying security title are attached at the time of acceptance; or

3. The storage in the United States or in any foreign country of readily marketable staples,[1] provided that the bill is secured at the time of acceptance by a warehouse, terminal, or other similar receipt, conveying security title to such staples, issued by a party independent of the customer, and provided further that the acceptor remains secured throughout the life of the acceptance. In the event that the goods must be withdrawn from storage prior to the maturity of the acceptance or the retirement of the credit, a trust receipt or other similar document covering the goods may be substituted in lieu of the original document, provided that such substitution is conditioned upon a reasonably prompt liquidation of the credit. In order to insure compliance with this condition it should be required, when the original document is released, either (*a*) that the proceeds of the goods will be applied within a specified time toward a liquidation of the acceptance credit, or (*b*) that a new document, similar to the original one, will be resubstituted within a specified time.

Provided, That acceptances for any one customer in excess of 10 per cent of the capital and surplus of the accepting bank must remain actually secured throughout the life of the acceptance, and in case of the acceptances of member banks this security must consist of shipping documents, warehouse receipts, or other such documents, or some other actual security growing out of the same transaction as the acceptance, such as documentary drafts, trade acceptances, terminal receipts, or trust receipts which have been issued under such circumstances, and which cover goods of such a character, as to insure at all times a continuance of an effective and lawful lien in favor of the accepting bank, other trust receipts not being considered such actual security if they permit the customer to have access to or control over the goods.

A Federal Reserve bank may also discount any bill drawn by a bank or banker in a foreign country or dependency or insular possession of the United States for the purpose of furnishing dollar exchange as provided in Regulation C, provided that it has a maturity at the time of discount of not more than 3 months, exclusive of days of grace.

Sec. XII. Maturities.—*a. Legal Requirements.*—No such acceptance is eligible for discount which has a maturity at the time of discount in excess of 90 days' sight, exclusive of days of grace, except that acceptances drawn for agricultural purposes and secured at the time of acceptance by warehouse receipts or other such documents conveying or securing title covering readily marketable staples may be discounted with maturities at the time of discount of not more than 6 months' sight, exclusive of days of grace.

b. General Conditions as to Maturity of Domestic Acceptances.—Although a Federal Reserve bank may legally discount an acceptance having a maturity at the time of discount not greater than that prescribed under (*a*) it may decline to discount any acceptance the maturity of which is in excess of the usual or customary period of

[1] A readily marketable staple within the meaning of these regulations may be defined as an article of commerce, agriculture, or industry of such uses as to make it the subject of constant dealings in ready markets with such frequent quotations of price as to make (*a*) the price easily and definitely ascertainable, and (*b*) the staple itself easy to realize upon by sale at any time.

credit required to finance the underlying transaction or which is in excess of that period reasonably necessary to finance such transaction. Since the purpose of permitting the acceptance of drafts secured by warehouse receipts or other such documents is to permit of the temporary holding of readily marketable staples in storage pending a reasonably prompt sale, shipment, or distribution, no such acceptance should have a maturity in excess of the time ordinarily necessary to effect a reasonably prompt sale, shipment, or distribution into the process of manufacture or consumption.

Sec. XIII. Evidence of Eligibility.—A Federal Reserve bank must be satisfied, either by reference to the acceptance itself or otherwise, that the acceptance is eligible for discount under the terms of the law and the provisions of this regulation. The bill itself should be drawn so as to evidence the character of the underlying transaction, but if it is not so drawn, evidence of eligibility may consist of a stamp or certificate affixed by the acceptor in form satisfactory to the Federal Reserve bank.

REGULATION G, SERIES OF 1928

(Superseding Regulation M of 1926)

R·DISCOUNT OF NOTES SECURED BY ADJUSTED SERVICE CERTIFICATES

Sec. I. Statutory Provisions.—Under the terms of the World War adjusted compensation act as amended, loans may lawfully be made to veterans upon their adjusted service certificates only in accordance with the provisions of Sec. 502 thereof.

Any national bank, or any bank or trust company incorporated under the laws of any state, territory, possession, or the District of Columbia is authorized, after the expiration of 2 years after the date of the certificate, to loan to any veteran upon his promissory note secured by his adjusted service certificate any amount not in excess of the loan value of the certificate, which is stated on the face of the certificate. The law provides that the rate of interest charged upon the loan by the lending bank shall not exceed by more than 2 per cent per annum the rate charged at the date of the loan for the discount of 90-day commercial paper by the Federal Reserve bank of the Federal Reserve district in which the lending bank is located.

Upon the indorsement of any bank, which shall be deemed a waiver of demand, notice and protest by such bank as to its own indorsement exclusively, and, subject to regulations to be prescribed by the Federal Reserve Board, any such note secured by an adjusted service certificate and held by a bank is made eligible for rediscount with the Federal Reserve bank of the Federal Reserve district in which such bank is located, whether or not the bank offering the note for rediscount is a member of the Federal Reserve System and whether or not it acquired the note in the first instance from the veteran or acquired it by transfer upon the indorsement of any other bank; provided that at the time of rediscount such note has a maturity not in excess of 9 months, exclusive of days of grace, and complies in all other respects with the provisions of the law, the regulations of the United States Veterans' Bureau, and the regulations of the Federal Reserve Board.

Theory and Policies Underlying Eligibility Provisions.—During the early days of Federal Reserve boards policy, an effort was made to change the commercial-credit practices of this country in directions

thought to be an improvement. For example, considerable effort was made to induce business houses to finance their transactions by means of trade acceptances, and for the purpose of accomplishing this, preferential discount rates were granted to trade acceptances. There was also an effort made to reduce the maturity period of the paper by a system of graded rates. After a relatively short experiment in preferential and graded rates, the practice was abolished and a single flat rate used instead. An early effort to discover the exact use to which the proceeds of commercial paper were put was abandoned and instead of that the assumption was made of commercial use if the financial statement of the borrower indicated a good current ratio, that is, a substantial excess of quick assets over current liabilities. The limitation of discount privileges to self-liquidating commercial paper was based upon the theories that the Federal Reserve System being custodian of the Reserve banking system, should keep its assets in a highly liquid state, and as commercial banks only are members of the system, presumably this would include a substantial part of the member banks' assets and would further discourage the commercial banks from extending too much credit along investment lines. While sound commercial-banking practice is undoubtedly fostered by this emphasis upon high-grade, self-liquidating commercial paper, the fact remains that a large portion of the assets of member banks is denied eligibility, and the Federal Reserve System thereby loses some degree of control over banking operations which relate to commercial banking, but do not follow strictly within that field.

A great deal of defect naturally arose in the effort to distinguish between commercial and investment activities. There is obviously no sharp dividing line, and, consequently, no hard and fast rule can be applied. The actual decisions of the board seem arbitrary in many instances. The rulings are too numerous to be cited and analyzed in detail. Generally speaking, however, they have favored the agricultural community. Anomalous situations constantly arise. For example, a note given by a buyer to a seller for goods purchased is commercial paper owned by the seller and eligible if the seller discounts it at a member bank, even though the buyer is going to use the goods for an investment purpose. But if the buyer issued his own notes and sold them in the open market for the purpose of obtaining cash to pay the seller for the same goods, these notes would be ineligible, if the goods were to be used for investment purposes. The result from this is that paper arising out of the same transaction may be eligible or ineligible, depending upon the form of paper used. If double-name paper, the

notes are eligible; if single-name, the eligibility is determined by the use to which the goods purchased by the proceeds are put.

Where the test of the use of the proceeds is applied, it is held that the proceeds must be used in the first instance for some commercial or agricultural purposes. Therefore, if the proceeds are to be used to lend to someone else, to be used by the borrower for a commercial or agricultural use, the paper is not eligible. The Agricultural Credits Act of 1923 made an exception to this in declaring eligible for discount the notes, drafts or bills of exchange of a factor if the proceeds are to be loaned to a farmer for agricultural purposes.

CHAPTER XXXI

FEDERAL RESERVE DISCOUNT POLICIES

The inauguration of the Federal Reserve System came at a particularly unfortunate time, at least in so far as the system, itself, was concerned. The World War broke out July 6, 1914, and the Federal Reserve System was inaugurated Nov. 16, 1914, at a time when the financial institutions of the United States were practically demoralized because of the drains made upon them by European creditors. During that fateful summer, the New York Stock Exchange had to close its doors for a period of over three months and an attitude of uncertainty was hovering over the entire country, because of the catastrophe which had so suddenly come upon the world.

The Federal Reserve authorities had the task of completely organizing the new banking system, including the twelve Federal Reserve banks. After the system had been organized and the operations of the banks had commenced, policies had to be decided upon by officials most of whom had had no previous experience with central banking institutions. European countries had long been familiar with so-called discounting and open-market operations of central banks, but in this country these were new operations.

The fixing of the discount rate by a central bank has been largely influenced by the action of the market rate or rates, and it usually bears a distinct relation to those rates. It is important to understand which of the rates commonly quoted in the money market is to be regarded by the central bank authorities as the market rate.

An examination of the policies of the Bank of England in the London money market indicates that when the bank rate is contrasted with the market rate, reference is really being made to the relation of the official discount rate of the Bank of England, comparing it to the current rate on bills of exchange. This is unlike the situation in this country, where the discount rate is applicable to all types of eligible paper offered by the member banks, irrespective of other considerations. The following quotation from the Tenth Annual Report of the Federal Reserve Board is illustrative of the fact that discount rates in

both the London and the New York market are not always higher than market rates for certain types of paper.

A comparison of the rate structure of the New York market with that of the London market brings out that in the New York market the official discount rate of the Federal Reserve bank is also above the open-market rate on that class of paper, to wit, bankers' acceptances, most nearly comparable to the bills which are the principal type of paper in the London market. A comparison further shows that in London, as in New York, the bulk of the loans made by commercial banks to their customers are at rates higher than the bank rate in London or the Federal Reserve discount rate in New York.

English banking practice does not, therefore, establish the inference that Federal Reserve bank discount rates in order to be effective must be penalty rates—that is, be higher than the rates charged by member banks on customer loans. Little in the way of good would result from any attempt to adopt or set this up as the regulative principle in the adjustment of Reserve bank rates.

There is an important difference between the relationship sustained by member banks to their Federal Reserve banks and by London Joint Stock banks to the Bank of England. When member banks lend money to their customers, they obtain from them promissory notes which are eligible for rediscount with the Federal Reserve bank. The London Joint Stock banks, on the other hand, make most of their loans to customers in the form of overdrafts or advances which do not result in negotiable instruments and therefore cannot be converted into balances at the Bank of England. The temptation which is present under the American banking system to rediscount customer paper and relend the proceeds because of the profit arising from such rediscount, when the Federal Reserve bank rate is sufficiently below the customer rate to make such a transaction profitable, is not present under the English system.[1]

It is difficult to determine accurately what current market rates are, because of the many types of available loans. This is even true in a market like the New York market where rates of interest on call loans differ materially from the rates of interest on short-time commercial paper or on bankers' acceptances.

The formulation of Federal Reserve discount policies had to take these facts into consideration, and as shown in the quotation above, the discount rate, in practice, is usually above the open market rate on bankers' acceptances.

Early Policies.—At the outset a great deal of apprehension among the commercial bankers existed concerning the purpose of the Federal Reserve System. Many bankers thought that it represented an attempt on the part of a governmental body to supervise their activities, and accordingly they became suspicious of the whole affair. The

[1] Annual Report of the Federal Reserve Board (1923), pp. 8 and 9.

Federal Reserve Act, itself, did not specify except in general terms what discount policy should be followed by the Federal Reserve Board and banks, and therefore before a policy could be decided upon, much discussion took place. Some felt that uniform discount rates should prevail throughout the country. Others were of the opinion that the rate should vary depending upon conditions within the several reserve districts; and some of the officials, bearing in mind the traditional banking policy of the Bank of England, thought that the discount rate should always be above the market rate. As stated previously, this was very hard to define.

A very serious problem facing central bank administration in this country is the fact that a wide divergence of interest rates exists in the various parts of the United States. Thus, in some states, 12 per cent is the legal rate charged borrowers; and in other states there is no legal rate specified. If the Federal Reserve banks were to fix a uniform bank rate of 6 per cent it would mean that in some districts the bank rate would be above the market rate, while in other districts it would be below the rates usually charged borrowers.

The question was also raised: "Should the Federal Reserve banks be regarded as emergency institutions, or should they function in so far as their rediscounting was concerned, at all times?" The early decision was made in favor of the Federal Reserve banks rediscounting eligible paper freely at all times. The rates initially fixed are shown in the tables on pp. 422 and 423.

The Federal Reserve authorities soon found out, however, that the member banks were not inclined to rediscount commercial paper with the Reserve banks, because of a slight business depression and the natural hesitancy on the part of the member banks to use the reserve facilities, some feeling that to do so was an evidence of weakness. It was not long before efforts were made to induce several of the leading urban banks to rediscount eligible paper, and thus set the fashion; while, at the same time, lower rates were established by the banks, the lowest rate being $4\frac{1}{2}$ per cent for 30-day paper.

Rates during 1915.—During 1915, discount rates were steadily reduced and it was the policy of the board to work towards uniformity of rates for the entire country. In fact, the board states that, "It may not be practicable to maintain uniform rates throughout the twelve districts, but they should unquestionably bear a consistent relation one to another, while a very much greater adherence to uniformity than before the enactment of the Federal Reserve Act will undoubtedly be secured."[1]

[1] Report of Federal Reserve Board (1915), p. 5.

REDISCOUNT RATES,[1] FEDERAL RESERVE

	Boston	New York	Philadelphia	Cleveland	Richmond
1914: 30- to 60-day paper	11/16–6% 12/17–5½ 12/30–5	11/16–6% 12/18–5½ 12/23–5	11/16–6% 12/16–5½ 12/28–5	11/16–6% 12/16–5½	11/16–6% 12/17–5½ 12/28–5
1915: 30- to 60-day paper	2/3–4	2/3–4½ 2/18–4	2/28–4	1/14–5 2/6–4	1/27–4½ 6/25–4
1916: 31- to 60-day paper				8/1–4½	
1917: 16- to 60-day paper	12/5–4½ 12/12–5	12/21–4½	11/26–4½	12/1–4½	11/30–4½
1918: 16- to 60-day paper	1/1–5 4/8–4¾	1/1–4½ 4/3–4¾	1/1–4½ 4/8–4¾	1/1–4½ 4/8–4¾	1/1–4½ 4/8–4¾ 5/20–5 12/30–4¾
1919: 16- to 90-days					
1920: Maturing before 90 days	1/23–6 6/4–7	1/23–6 6/1–7	1/23–6	1/12–5 1/28–6	1/23–6
1921: All paper	4/15–6 7/21–6 9/23–5 11/4–4½	5/5–6½ 6/16–6 7/21–5½ 9/22–5 11/3–4½	7/21–5½ 10/5–5 11/3–4½	8/8–5½ 11/7–5	11/3–5½ 12/10–5
1922: All classes and maturities	6/23–4	6/22–4		2/14–4½	4/14–4½
1923: All classes and maturities	2/23–4½	2/23–4½			
1924: All classes and maturities	6/12–3½	5/1–4 6/12–3½ 8/8–3	6/19–3½ 6/26–3½	6/2–4 8/15–3½	6/14–4
1925: All classes and maturities	11/10–4	2/27–3½	11/20–4	11/17–4	
1926: All classes and maturities		1/8–4 4/23–3½ 8/13–4			
1927: All classes and maturities	8/5–3½	8/5–3½	9/8–3½	8/6–3½	8/16–3½
1928: All classes and maturities	2/8–4 4/20–4½	2/3–4 5/18–4½	2/16–4 5/17–4½	3/1–4 5/25–4½	1/27–4 4/24–4½

[1] The dates when rates were made are indicated.

BANKS, 1914–1928. COMMERCIAL PAPER

Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
11/16-6½% 12/2-6 12/15-5½ 12/28-5	11/16-6% 12/16-5½	11/16-6% 12/21-5½	11/16-6½% 12/7-6 12/24-5½	11/16-6½% 12/4-6 12/15-5½	11/16-6½% 12/1-6 12/18-5½ 12/30-5	11/16-6½% 12/2-6 12/15-5½
1/21-4 3/18-4½ 4/30-4	1/1-5 1/23-4	1/7-5 2/4-4	1/9-5 2/19-4½ 5/18-4	1/8-5 1/28-4	1/13-4½ 1/27-4	1/8-5 1/22-4
	7/12-4½ 8/31-4			4/12-4½		
12/1-4½	11/30-4½	12/11-4½	12/5-4½		12/5-4½	12/10-4½
1/1-4½ 4/8-4¾	1/1-4½ 4/8-4¾	1/1-4½ 4/8-4¾	1/1-4½ 4/8-4¾	1/1-4½ 4/8-4¾ 5/20-5¼ 9/20-5	1/1-4½ 4/15-4¾	1/1-4½ 4/8-4¾ 8/29-5
					11/10-5	12/26-4¾
1/26-6 11/1-7	1/24-6 6/1-7	1/24-6	1/26-6 6/1-7	1/23-6	2/2-6	2/2-6
5/6-6 11/2-5½ 12/19-5	5/7-6½ 7/30-6 11/3-5	11/3-5	5/10-6½ 10/5-6 11/7-5½	11/2-5	2/15-7 5/16-6½ 6/25-6 11/4-5½	7/25-5½ 11/2-5
3/15-4½	3/25-4½	4/6-4½	1/11-5 8/15-4½	8/12-4½	1/9-5 7/12-4½	1/23-4½ 7/8-4
						3/6-4½
6/18-4	6/14-4	6/19-4	10/15-4	7/1-4	7/16-4	6/10-4 8/25-3½
						11/23-4
8/13-3½	9/7-3½	8/9-3½	9/13-3½	7/29-3½	8/12-3½	9/10-3½
2/11-4 5/26-4½	1/25-4 4/20-4½	2/21-4 4/23-4½	2/7-4 4/25-4½	2/10-4 6/7-4½	2/8-4 5/7-4½	2/4-4 6/2-4½

Rates during 1916.—At the close of 1915, the rates varied from 4 to 4½ per cent. The demands of the belligerent European powers for materials of war in 1916 led to a high degree of business activity throughout the country. Throughout the year rates stayed up around 4½ per cent. The following table indicates the fact, however, that rediscounting was not resorted to on a large scale until after April, 1917, when the United States entered the World War.

TOTAL AMOUNTS OF COMMERCIAL PAPER, EXCLUSIVE OF ACCEPTANCES, DISCOUNTED BY THE FEDERAL RESERVE BANKS

(Volume of rediscounting, 1914–1927)

1914 (Nov. 16 to Dec. 26)	$21,411,000	1921	$57,759,128,000
1915	161,353,000	1922	22,082,887,000
1916	207,870,500	1923	38,379,926,000
1917	9,014,186,454	1924	15,419,155,000
1918	39,752,933,847	1925	32,562,620,000
1919	79,173,969,730	1926	37,682,137,000
1920	85,320,874,000	1927	31,934,607,000

Discounting during the World War.—With the entrance of the United States into the World War, business expanded very rapidly, and a resultant drain on the banks occurred. In addition, the allied countries were in a very serious financial condition, and while the United States could not send military forces to Europe immediately, it could extend immediate assistance in the form of credit. This necessitated the raising of large sums by the government and it was decided to utilize the services of the Federal Reserve System, as the fiscal agency of the government. In his report to Congress the Secretary of the Treasury made acknowledgment of the services rendered by the Federal Reserve banks as follows:

> The Federal Reserve System has been of incalculable value during this period of war financing on the most extensive scale ever undertaken by any nation in the history of the world. It would have been impossible to carry through these unprecedented financing operations under our old banking system. The effective machinery afforded by the Federal Reserve banks has permitted the government to execute its plans without a tremor of disturbance. Great credit is due the 12 Federal Reserve banks for their broad grasp of the situation and their intelligent and comprehensive cooperation.[1]

The member banks were encouraged to borrow from the reserve banks in a circular letter issued by the Federal Reserve Board, May 22, 1917. This letter authorized the reserve banks to discount paper of

[1] Annual Report of the Federal Reserve Board, 1917, p. 4.

non-member banks, secured by government collateral, and when indorsed by a member bank. Also in line with its policy, the Federal Reserve Board fixed a preferential rate on short-term notes, secured by government collateral. This last action encouraged the banks to discount, freely, paper secured by government bonds, and thus expand the market for such issues. The war financing on the part of the government did not cease until after the Victory loan had been floated in 1919.

The Federal Reserve Board took measures to speed up the creation of credit, and modified the discount schedules as follows:

1. The establishment of a rate of 3 per cent per annum for the discount at Federal Reserve banks of notes of member banks running not longer than 15 days secured by Treasury certificates of indebtedness, which certificates had been issued at rates varying from 3 to 3½ per cent per annum.

2. The establishment of a rate of discount at Federal Reserve banks, of 3½ per cent per annum for customers' notes running up to 90 days, secured by government obligations and indorsed by member banks, when such notes had been made for the purpose of obtaining funds for the purchase of government obligations.

3. The authorization of Federal Reserve banks to discount for member banks, on behalf of non-member banks, notes of non-member banks or their customers, secured by government obligations, for the purpose of obtaining funds with which to purchase United States bonds or notes.

4. The establishment of a 1-day rate of from 2 to 4 per cent at New York for the purpose of restoring to the market, funds temporarily withdrawn through government loan operations.[1]

During 1918, the system continued policies which were predicated primarily upon the needs of the Treasury Department. In view of the fact that the Treasury Department had raised the coupon rate of the Liberty Loan bonds of the third and fourth issues, it became necessary for the board to increase slightly the discount rates at all Reserve banks.

Policies through 1919.—In studying the discount policies of the Federal Reserve Board, it is interesting to note the following quotations from the Sixth Annual Report of the Federal Reserve Board:

The experience of the past 3 years has demonstrated the expansive power of the Federal Reserve System. It should be understood, however, that an elastic system of reserve credit and note issue implies capacity to control and the ability to curtail credit. The ability of the system to check expansion under present circumstances and to induce healthy liquidation is now to be tested.

[1] Annual Report of the Federal Reserve Board (1917), pp. 5–6.

Owing to the abnormal ease of money throughout the year 1915 and during the greater part of the year 1916, the board had little opportunity to test the efficiency of what it conceived to be the correct discount policy. The principle had been adhered to consistently that the Federal Reserve banks should not encourage rediscounting by member banks for the sake of profit, but that their own resources should be kept liquid and their reserve position strong.

Although Sec. 5202 of the Revised Statutes, which provides that no national banking association shall at any time be in any way liable for borrowed money to an amount exceeding the amount of its capital stock, had been amended by excepting liabilities incurred under the provisions of the Federal Reserve Act, it was not contemplated by the board that the member banks would, except to meet seasonal requirements or emergencies, avail themselves of this amendment in order to extend their rediscount lines beyond the original limitations. It was the board's view also that as a rule the discount rates of the Federal Reserve banks should be higher than current market rates, thus offering no incentive to member banks to rediscount for the sake of making a profit in the transaction.

Because of this policy and of the conditions which prevailed up to the time when it began to appear that the United States would be drawn into the war, the reserve position of the Federal Reserve banks was so strong as to suggest an analogy between the system and a safe deposit vault.

In his address to Congress, urging the declaration of a state of war with Germany, the President pledged all the resources of the nation—which, of course, include its man power, money, credit, and goods—to the successful conduct of the war. By an overwhelming vote the Congress of the United States carried out the recommendations of the President, thus committing the country to the principles and policies outlined in his address.

Normal policies had to be subordinated, just as private business was subordinated, to government business, and discount rates were of necessity fixed with the primary object of assisting the Treasury operations. How effective this policy was is now a matter of history. As has already been pointed out, the Federal Reserve banks became great bond-distributing organizations; firms and corporations, large and small, men and women in every walk of life, were urged to subscribe for bonds, and the credit facilities of the Federal Reserve banks were placed at the disposal of member and non-member banks in order that they might lend freely on bonds for which the subscribers were unable to pay. The public was urged to borrow and buy, and it was found after the close of the Victory Loan in May, 1919, that more than 20,000,000 subscriptions had been received in response to this appeal.

But in addition to the appeal to borrow and buy, there was also added the injunction to save and pay. To assist this process, during the 18 months when the war was in progress, there was established a rigid control of such credits as were not essential, directly or indirectly, to the prosecution of the war, and the American people proved their ability to economize and to cooperate in the nation-wide policy of conservation. As a result of this control of non-essential

credits, and the cooperation of the banks and the public, the treasury was able to loan within a period of two years $25,000,000,000 of interest-bearing obligations without reducing the reserves of the Federal Reserve banks below a point which in normal pre-war times would have been regarded as a very strong reserve for a central bank.

The combined reserves of the 12 Federal Reserve banks on Jan. 3, 1919, amounted to 51.3 per cent of their liability for deposits and note issues. Due partly to the gold embargo, this percentage was well maintained during all the period of uncertainty which preceded the flotation of the Victory Loan and for some time thereafter, for not until July 9, after the gold embargo had been removed, did the reserves fall even fractionally below 50 per cent. On Sept. 26 reserves stood at 51 per cent, after which date they show a steady and continuous decline to 44.8 per cent on Dec. 26.

Although the period of war financing did not terminate with the year 1918 and the Federal Reserve System was consequently under the continued strain of war finance, that strain had to be met without the aid of war restrictions. The safeguards afforded by these restrictions were removed, for it was impracticable to continue them in time of peace. There is no longer an embargo on exports of gold nor any regulation or control of foreign exchange, with the trifling exceptions already noted; the controls set up over exports and imports, production and consumption, with a view of conserving the national resources and reducing waste, have practically disappeared. As a result, the problems of the Federal Reserve System have been greatly increased, more particularly the problem of controlling credit.

The Federal Reserve System has met the requirements of war and readjustments, by expanding, without, however, encroaching upon its legal reserves; it is capable, if need be, of expanding still further without having recourse to the emergency provisions of the act, and very much further by availing itself of those provisions. But the time has come for it to demonstrate its power to move in the opposite direction, and to prove its ability to do so without shock and with a minimum disturbance of business and industry.[1]

The above quotations indicate the problems which faced the Federal Reserve Board during the war years, and which made it necessary for them to formulate inflationary policies.

A glance at the table on page 424 indicates the extent to which rediscounts increased immediately after the declaration of war. It can be said that the whole efforts of the Federal Reserve System were put forth towards winning the war; as a result, the currency of this country was greatly inflated and the system, itself, inaugurated a policy of low discount rates. It was during the year 1919 that the greatest amount of rediscounting was done by the system, and that was the period of most rapid inflation.

[1] Annual Report of the Federal Reserve Board (1919), pp. 67, 68, and 69.

In the latter part of 1919, considerable criticism appeared concerning the rapid rise in commodity prices, and many students of banking were of the opinion that the Federal Reserve System should raise discount rates in order to discourage borrowing from the banks, and to encourage the contraction of credit and currency. It was not, however, until November, 1919, that the board started to raise its rates.

Policy during 1920.—During the year 1920, rates were advanced at all the Federal Reserve banks, first, in the latter part of January, and then towards the end of May, when the discount rates of some of the Federal Reserve banks went to 7 per cent for paper of 90 days' maturity. Regarding the exigencies of Treasury-department financing over for the present, the board took the position that sound banking principles made it mandatory upon the system to curtail the speculation which was taking place in all fields of endeavor, and which had resulted in the rapid rise in commodity prices. They therefore clearly adopted, for the time being, a deflationary policy.

These measures took the following form: [1]

1. The issuance of warnings;
2. The use of moral suasion;
3. The advising banks to reduce their outstanding lines of credit and to discriminate against speculative and non-essential loans;
4. The rationing of credit;
5. The attempt to drive war paper from the portfolios of Reserve and member banks;
6. Controlling the issue of Federal Reserve notes;
7. The closer scrutiny of paper offered for discount;
8. Advances in the bank rates.

There occurred, in March, 1920, in Japan, the collapse of the silk market, which was caused by the rapidly declining price of silk. This was but a forerunner of a decline in prices which was to be world wide. Thus, in the United States, the decline in prices came about so rapidly that a serious depression set in.

Policy in 1921.—The Federal Reserve Board seemed intent on a vigorous policy of rapid deflation, which has since been subject to considerable criticism. Some authorities believe if Federal Reserve discount rates had been lowered in the fall of 1920, the extent of the price decline and the severity of the attendant business depression would have been lessened. It was not until May, 1921, however, that the board authorized the lowering of the rediscount rates, and by the end of

[1] Beckhart, B. H., "The Discount Policy of the Federal Reserve System," pp. 351 and 352, Henry Holt & Company, New York, 1924.

the year the rates of the twelve Federal Reserve banks varied from 4½ per cent to 5½ per cent. During this whole period, however, the Federal Reserve banks were compelled to take on many loans which were eligible under the act in so far as collateral was concerned, but which, because of falling prices, would become more or less *frozen* in the portfolio of the Federal Reserve banks. In other words, the market value of the collateral behind the paper depreciated so rapidly that the original borrower of the credit could not hope to repay the loan from the proceeds of the resale of the commodity, and, therefore, the Federal Reserve banks were left in the position of holding the loan until such time as the market recovered, and enabled the original borrower to get sufficient return from the sale of the commodity to enable him to repay the loan.

In 1921, a single discount rate became applicable to all types of eligible paper, irrespective of character or maturity. During the latter part of 1921, gold commenced to flow back to the United States from Europe in large amounts. During the period from Nov. 5, 1920, to Dec. 28, 1921, the reserve ratio advanced 28 per cent, from 43 to 71 per cent.[1] Most of this gain was attributed to the addition of over $800,000,000 to the gold reserves of this country which represented in the main liquidation of bank credit due to the payment by foreign borrowers of obligations contracted in this country.

The table on page 430 indicates the fluctuations in the reserve ratio:

Policy in 1922.—Discount rates continued to fall during the first half of 1922, when rates ranging from 4 to 4½ per cent were established at the several Federal Reserve banks. During this year the United States imported about $238,000,000[2] of gold, which had its effect upon the reserve ratio.

The Federal Reserve System again was faced with a very serious inflation of currency and credit, this time because of the abnormal supply of gold, which was attracted to the United States. It was seriously suggested that the Federal Reserve System ignore completely the new gold coming into this country, by setting aside a large portion of it. It was thought that only a matter of time would elapse before the gold would have to be reshipped to Europe. However, the system undertook to control the situation by inserting a new item, *Gold Held Exclusively against Federal Reserve Notes* in the weekly statement of condition of the banks, and began to issue Federal Reserve notes on the security of 100 per cent gold, therefore making them in

[1] Annual Report of the Federal Reserve Board (1921), p. 27.

[2] Annual Report of the Federal Reserve Board (1922), p. 13.

FEDERAL RESERVE RATIO

Date	Per cent *	Date	Per cent *
Nov. 27, 1914	104.2	June 30, 1922	77.9
Dec. 31, 1914	100.5	Dec. 30, 1922	72.7
June 25, 1915	99.1	June 30, 1923	76.7
Dec. 30, 1915	95.3	Dec. 31, 1923	75.3
June 30, 1916	82.6	June 30, 1924	83.7
Dec. 29, 1916	81.4	Dec. 31, 1924	73.0
June 29, 1917	75.4	June 30, 1925	75.7
Dec. 28, 1917	63.6	Dec. 31, 1925	69.0
June 28, 1918	61.7	June 30, 1926	75.3
Dec. 27, 1918	50.6	Dec. 31, 1926	71.4
June 27, 1919	52.1		
Dec. 26, 1919	44.8	From Fed. Res. *Bulletins*:	
June 25, 1920	43.6	June 29, 1927	77.6
Dec. 30, 1920	45.4	Dec. 28, 1927	66.8
June 30, 1921	60.8	June 27, 1928	68.7
Dec. 31, 1921	70.2	Dec. 26, 1928	61.6

* Figures for 1914 to 1926, inclusive, from Annual Report of Federal Reserve Board, 1926, pp. 43–45. Reserve percentages for dates prior to June, 1917, have been calculated on a basis comparable with figures published subsequent to the passage of the June 21, 1917, amendment to the Federal Reserve Act which provides that gold with Federal Reserve agent may be counted as part of bank's required reserve.

effect gold certificates. While it is true that this method prevents the issuance of a large amount of Federal Reserve notes, yet it reduces the elasticity of those notes issued on a basis of 100 per cent gold security.

Policy during 1923, 1924, and 1925.—During 1923, discount rates underwent very few changes; the Reserve banks of Boston, New York, and San Francisco were the only banks to change their rates, advancing them from 4 to 4½ per cent. According to the statement of the Federal Reserve Board, "the effect of the rate advances of the three banks was to bring about a better regional distribution of credit and to test the character and soundness of the credit demand by having the obligations of borrowers passed upon by banks in their own locality." [1] During 1924, there was an obvious attempt on the part of the Federal Reserve System to encourage trade activity, and discount rates were reduced between May and the middle of October, 1924, to a level ranging at the different banks between 3 and 4 per cent. During the first 2 months of 1925, discount rates were advanced at the New York bank, and in

[1] Annual Report of the Federal Reserve Board (1923), p. 4.

November the rates were fixed at 4 per cent at all banks with the exception of the New York bank. The Federal Reserve Board, in its report, points out in connection with the fact that the New York Federal Reserve Bank did not see fit to raise its rate at this time, that:

> The New York money market . . . is the point of contact with foreign central money markets, and changes in money rates in New York tend to influence the international movement of funds and of gold. In the autumn months, when seasonal trade movements tend to bring about gold imports, there was a net movement of gold to the United States, and, in view of the influence which gold imports have upon the banking situation in this country, the desirability of not adding further to the gold inflow was a factor in the decision not to advance the discount rate at the New York bank in November.[1]

Policy during 1926.—During 1926, the credit policies of the Reserve System were to maintain the discount rates at the Reserve banks unchanged at 4 per cent, except for adjustment at the New York bank, which was considered necessary because of the rapid increase in the amount of credit going into the financing of stock-market transactions.

Policy in 1927.—During the summer of 1927 a slight recession in business occurred and in addition the Federal Reserve System was faced with the problem of assisting a number of the European countries to reestablish their currencies on the gold basis. It was thought desirable that gold should be encouraged to move to Europe, and consequently the rates in this country should be somewhat lower than those abroad. Keeping this desire in mind, the Federal Reserve Board encouraged, and in some cases advised, the Federal Reserve banks to lower their rates. In referring to their policy the board states:

> This policy was adopted by the system in consideration of the recession in business in the United States, of the relatively heavy indebtedness of member banks, and of the tendency toward firmer conditions in the money market. During this period it also became evident that there was a serious credit stringency in European countries generally, and it was felt that easy money in this country would help foreign countries to meet their autumn demand for credit and exchange without unduly depressing their exchanges or increasing the cost of credit to trade and industry. Easier credit conditions abroad would also facilitate the financing of our exports and would thus be of benefit to American producers. By purchasing securities at that time, the Federal Reserve banks were in fact successful in easing the condition of the money market and in exerting a favorable influence on the international financial situation.[2]

[1] Annual Report of the Federal Reserve Board (1925), p. 6.

[2] Annual Report of the Federal Reserve Board (1927), p. 10.

A great deal of discussion occurred in the press concerning this situation, and one of the Federal Reserve banks, namely, that of Chicago, vehemently protested against the request of the Federal Reserve Board. The Chicago bank took the viewpoint that it was undesirable at the time to lower the rates. The board, however, prevailed in its policy, and the rate of the Chicago bank was lowered to $3\frac{1}{2}$ per cent in conformity with the rates of the other banks, uniform rates prevailing throughout the 12 Federal Reserve districts. During this period, exports of gold continued in large amounts, with the result that the banking reserves were substantially lowered.[1]

[1] The gold flow into and out of the country, which was thus a major factor in the credit situation in 1927, has exerted an important influence on banking conditions in the United States since the beginning of the Federal Reserve System. Between June 30, 1914, and Dec. 31, 1927, the stock of monetary gold in the United States increased from $1,891,000,000 to $4,376,000,000, an increase of $2,485,000,000, of which $2,071,000,000 represented reported net imports less amounts earmarked for foreign account, and $414,000,000 additions to gold stock from other sources, chiefly excess of domestic production over consumption by industry and the arts.

From the point of view of gold movements, the history of the Federal Reserve System may be divided into five periods. (1) Between June, 1914, and April, 1917, when the United States joined the Allies in the war, there was a net import movement of gold amounting to $1,080,000,000. This gold came to the United States because European belligerents were in need of war supplies from America and sent gold to pay for them and to support the exchanges. In the United States, this gold became the basis for a considerable expansion of bank credit and gave rise to a condition of ease in the money market at a time when industrial activity was rapidly increasing to meet war demands. The Federal Reserve banks at that time had just begun to function, and the inflow of gold from abroad, together with funds released through the reduction of reserve requirements, supplied commercial banks with ample reserves and kept the Reserve banks out of touch with the market. (2) Between April, 1917, and June, 1919, gold movements in and out of the country were relatively small. During the greater part of the time an embargo on exportation of gold was in effect. In this period the gold of the country was mobilized by being concentrated at the Federal Reserve banks, where it became the basis for a large growth of bank credit used primarily to finance the war. (3) Between June, 1919, and September, 1920, there was an export of gold aggregating more than $380,000,000 to countries that had accumulated balances in the United States during the embargo and withdrew them when the embargo was lifted. (4) Between September, 1920, and December, 1924, gold flowed continuously into the United States, the net import movement for the period aggregating $1,660,000,000. This inflow of gold was due largely to the fact that Europe needed supplies of food and raw materials from this country for purposes of reconstruction and was obliged to export gold in order to balance its accounts. During this period Europe was off the gold standard, the basis of credit and currency. (5) Since December, 1924, gold movements have been on a much smaller scale. During this period of slightly over three years the United States as a whole has lost about $125,000,000

The movement of gold to Europe having absorbed about $500,000,000, the Federal Reserve authorities believed that sufficient gold had gone abroad to enable foreign monetary systems to be stabilized, and in line with this viewpoint, together with a fear of inflation in the securities markets in this country, the movement towards higher rates was started. In December, 1927, rediscount rates were raised to 4 per cent, and later on to 4½ per cent, which brought about a slight recession in the stock market.

The following quotation from the Federal Reserve *Bulletin* of June, 1928 (p. 373), is an indication of the development of the Federal Reserve discount policy:

Volume of bank credit continued to increase in recent weeks, and in the middle of May loans and investments of member banks in leading cities were at a new high level. The growth in bank credit has been continuous and rapid since the seasonal low point in the latter part of February. Since that time the total volume of credit extended by the reporting member banks has increased by nearly $1,000,000,000. Until the middle of April this growth reflected in about equal measure increased spring demands for bank accommodation by trade and industry and growth in the volume of stock-exchange loans. Since that time there has been no further growth in the commercial demand for credit, and the entire increase has been in holdings of securities and in loans on stocks and bonds, and particularly in loans to brokers and dealers in securities on the New York Stock Exchange. Accompanying an unprecedented volume of transactions on the exchange and a continued rise in security prices, the volume of so-called brokers' loans reached a record figure in the beginning of April and continued to increase until the middle of May. In view of the rapid expansion of bank credit, in the absence of additional commercial demand, and the increasing volume of bank loans used to finance transactions in securities, the Federal Reserve banks pursued further the policy begun in January of selling government securities, and thereby withdrawing funds from

of gold. Gold movements during this period were in large measure in response to central bank policies.

Toward the end of 1924 and in the early part of 1925 a large amount of gold was exported to Germany out of the proceeds of an international loan floated in accordance with provisions of the Dawes plan for the restoration of German monetary stability. In 1926, also, gold movements were largely in response to credit policies, imports coming chiefly from Australia, Chile, Mexico, and Japan, and exports going largely to Germany, leaving our of account large seasonal gold movements to and from Canada. In 1927, withdrawals from out gold stock were made chiefly by France, Argentina, and Brazil; gold was exported also to Poland and Belgium and towards the end of the year to England and the Netherlands. These exports occurred very largely either in connection with programs of monetary reform or as a consequence of central bank credit policies (Annual Report of the Federal Reserve Board, 1927, pp. 12, 13, and 14).

the money market. Additional withdrawals of funds were caused by the continued demand for gold for export. As a consequence of these withdrawals and some increase in the reserve requirements of member banks, there was a large increase in member bank borrowings at the Reserve banks, and the volume of discounts in May was larger than at any other time in the past 4 years. Heavy indebtedness of member banks at the Reserve banks was accompanied by a rise in open-market rates, and particularly in the rate on call money. Discount rates at the New York, Philadelphia, Cleveland, Atlanta, Dallas, Kansas City and San Francisco Reserve banks have been raised since the beginning of May from 4 to 4½ per cent and this rate is now in effect in all of the Federal Reserve banks.[1]

Policy during 1929.—The year 1929 will go down in the financial history of the United States as a momentous year. The Federal Reserve authorities were faced with a rapidly rising stock market, a rapid increase in investment-trusts issues and by an increasing tendency toward large-scale business organizations. Large business concerns had accumulated substantial surplus accounts, which rendered them independent of the commercial banks in so far as their own current needs were concerned. In addition many of these corporations started to lend part of their surplus funds in the call market, and such loans presented new problems of credit control to the Reserve authorities. The extent of credit going into stock-market activities is shown in the following table:

BROKERS' LOANS PLACED BY REPORTING MEMBER BANKS IN NEW YORK CITY *

(In millions of dollars)

	Jan. 6, 1926	Oct. 23, 1929	Nov. 27, 1929	Changes: Jan. 6, 1926, to Oct. 23, 1929	Changes: Oct. 23, 1929, to Nov. 27, 1929	Changes: Jan. 6, 1926, to Nov. 27, 1929
Total loans to brokers.	3,141	6,634	3,450	+3,493	−3,184	+309
For banks, total......	2,577	2,810	1,469	+233	−1,341	−1,108
For own account.....	1,338	1,077	831	−261	−246	−507
For out-of-town banks†	1,239	1,733	638	+494	−1,095	−601
For others...........	564	3,823	1,982	+3,259	−1,841	+1,418

* Federal Reserve *Bulletin*, p. 756, December, 1929.

† Includes an indeterminate amount for customers of these banks.

[1] Federal Reserve *Bulletin*, Vol. 14, No. 6, p. 373, June, 1928.

Under date of Feb. 2, 1929, the board addressed a letter to the Reserve banks containing a statement of its position regarding the credit situation. This letter stated:[1]

The firming tendencies of the money market which have been in evidence since the beginning of the year—contrary to the usual trend at this season—make it incumbent upon the Federal Reserve banks to give constant and close attention to the situation in order that no influence adverse to the trade and industry of the country shall be exercised by the trend of money conditions, beyond what may develop as inevitable.

The extraordinary absorption of funds in speculative security loans, which has characterized the credit movement during the past year or more, in the judgment of the Federal Reserve Board deserves particular attention, lest it become a decisive factor working toward a still further firming of money rates to the prejudice of the country's commercial interests.

The resources of the Federal Reserve System are ample for meeting the growth of the country's commercial needs for credit, provided they are competently administered and protected against seepage into uses not contemplated by the Federal Reserve Act.

The Federal Reserve Act does not, in the opinion of the Federal Reserve Board, contemplate the use of the resources of the Federal Reserve banks for the creation or extension of speculative credit. A member bank is not within its reasonable claims for rediscount facilities at its Federal Reserve bank when it borrows either for the purpose of making speculative loans or for the purpose of maintaining speculative loans.

The board has no disposition to assume authority to interfere with the loan practices of member banks so long as they do not involve the Federal Reserve banks. It has, however, a grave responsibility whenever there is evidence that member banks are maintaining speculative security loans with the aid of Federal Reserve credit. When such is the case, the Federal Reserve bank becomes either a contributing or a sustaining factor in the current volume of speculative security credit. This is not in harmony with the intent of the Federal Reserve Act, nor is it conducive to the wholesome operation of the banking and credit system of the country.

The Reserve authorities followed this warning by raising discount rates, which finally reached a peak of 6 per cent in August, 1929, at the New York bank. The eventful months of October and November, during which this country witnessed a stock-market panic, produced also a relaxation in discount policies and the rate at the New York bank was 4½ per cent in December, 1929.

[1] Federal Reserve *Bulletin*, p. 94, February, 1929.

The following quotations from the Federal Reserve *Bulletin* of March, 1929, are of interest:

> It is a generally recognized principle that Reserve bank credit should not be used for profit, and that continuous indebtedness at the Reserve banks, except under unusual circumstances, is an abuse of Reserve-bank facilities. In cases where individual banks have been guilty of such abuse, the Federal Reserve authorities have taken up the matter with officers of the offending banks and have made clear to them that their reserve position should be adjusted by liquidating a part of their loan or investment account rather than through borrowing. Abuses of the privileges of the Federal Reserve System, however, have not been general among the member banks. The tradition against continuous borrowing is well established and it is the policy of the Federal Reserve banks to maintain it. The Federal Reserve System must steer its course with reference to broader developments and longer time objectives than day-to-day or month-to-month changes in any particular line of credit. Principal among such objectives are the continuous provision of credit at reasonable cost in amounts adequate for the requirements of trade and industry and the safeguarding of our gold reserves, which are held in trust to meet future needs, against unduly rapid absorption through expansion of credit.

Factors Determining Discount Policies.—Generally speaking, it can be stated that the following factors should be taken into consideration in the determination of a discount policy: (*a*) the reserve position of the central bank; (*b*) business activity; (*c*) volume of bank borrowings from the reserve; (*d*) interest rates charged by member banks; (*e*) interest rates in the open market; (*f*) rate of interest on bankers' acceptances; (*g*) interest rates on time deposits; (*h*) commodity price levels, as affecting the volume of credit required; (*i*) the balance of trade and the flow of gold; (*j*) condition of the foreign exchanges; (*k*) condition of security market only as indicative of the supply of floating capital.

Reviewing the discount policies of the Federal Reserve System one is impressed by the lack of a clear-cut and vigorous policy, or policies. Seemingly the board has drifted along ever since its inception without knowing just where it wanted to go. Critics of the system take the viewpoint that the discount rate should always be above the market rate in order to lead the market. However, as has been discussed, it is evident that to determine accurately the market rate is in itself an impossible task. This is particularly evident in a country such as the United States, covering a vast extent of territory, varying in economic resources and financial maturity, and with the states in many cases

legally fixing the limits of interest rates. The Reserve authorities frequently contend that the rate above which the discount rate should always stand is the rate on bankers' acceptances, and they state, in practice, the discount rate is usually above that rate.

The Federal Reserve System has not determined a policy concerning the uniformity of rates. There seems to have been continual conflicts among the members of the board, themselves, as to whether the twelve districts should have uniform discount rates, or whether rates should vary with the local situation. This question should be decided and a consistent policy followed. The part that the Federal Reserve System is to play in international finance must be determined with resultant policies. In other words, if the Federal Reserve System is to assist the central banks of Europe to stabilize their respective currencies, it will be necessary for the Reserve System to formulate certain definite discount policies controlling gold movements quite different from policies which would be decided upon if this country were to adopt the suggestion of some bankers and isolate itself from European financial affairs. The problem of credit control, in so far as concerns the credit entering the securities markets, has to be solved on the basis of the scientific investigation of the facts rather than to follow a day-to-day-hit-or-miss policy.

It is a highly debatable question as to whether a central bank should control the stock exchanges, and attempt to dictate concerning the amount of credit which should be utilized in the security markets. Professor Cassel in a recent article said:

> The widespread idea that a central bank ought to control the stock exchanges and suppress any tendency to excessive speculation is a mistake that may easily lead the management of the currency along false lines. The seriousness of this danger has been proven by American experience during the last few months. After having raised its rates of discount to unusually high levels in order to combat the New York Stock Exchange speculation, the Federal Reserve System was too slow in reducing these rates when in the autumn the slackening in the rate of industrial progress reduced the stringency of the capital market. The consequence of this unnecessary restriction of the supply of means of payment was that the general level of commodity prices, as measured by Professor Fisher's index number, was forced down from 149—the average figure for 1928 and for July, 1929—to about 140 at the end of 1929. The economic depression against which America is now struggling is mainly a result of this lowering of the commodity price level. Had the Federal Reserve System persistently adhered to the program of keeping the general level of commodity prices constant, the breakdown of stock-exchange speculation would never have been able to cause any really serious disturbance to the production and trade of the

country, which, according to the most reliable reports, were in a quite sound situation.[1]

Another serious problem confronting the Reserve authorities is connected with the gradual decline in the amount of eligible paper in the portfolios of the member banks. This has been due largely to the rapid growth in the size of corporations and the resultant financial independence of these corporations in so far as their relations with commercial banks are concerned. Short-term commercial loans, creating eligible paper, are not needed by corporations with huge surplus funds. The member banks can still borrow on the security of government bonds, yet these also are declining in amount—with the Treasury Department annually redeeming substantial blocks. Thus, the member banks are to some extent each year faced with a lessening amount of eligible paper and a resultant decline in potential credit expansion. To overcome this situation, it has been suggested that either additional paper be made eligible for discount or that the member banks be authorized to borrow from the Reserve banks on the security of their general assets, provided a margin of safety exists and provided the borrowing member banks are well managed and in a healthy condition.

[1] Lloyds Bank, Limited, *Monthly Review*, p. 6, March, 1930.

CHAPTER XXXII

OPEN-MARKET OPERATIONS OF THE FEDERAL RESERVE SYSTEM

Prior to the passage of the Federal Reserve Act, this country, unlike other leading commercial countries, had no developed open discount market. By an open discount market is meant a place where buyers and sellers can regularly purchase and sell commercial paper at prices which are constant at any given moment for paper of the same type and class. Such a market does not have to be organized into a formal exchange, nor is it necessary that the market operations be carried on in a certain building. It is sufficient if the transactions are carried on in a locality where buyers and sellers can be in constant communication with each other, and where the prices of the transactions are matters of public knowledge, as distinguished from simply isolated transactions at prices determined primarily by an individual buyer and seller without cognizance of the prices of other buyers and sellers in simultaneous transactions.

This market is not designed for the original placement of commercial paper, which is handled by the banks and commercial paper houses, but is a market for the resale of such paper prior to maturity. In this respect it is analogous to the stock exchange, which is a market for the resale of stock securities that have been originally placed by investment bankers or other financial houses.

Functions of an Open Discount Market.—Such a market would promote the mobility of funds, by the sale of paper originating in localities where funds were needed, and the purchase of such paper by financial institutions in localities where funds were plentiful. In the absence of such a market, the movement of funds from one section of the country to another would be accomplished primarily by means of interbank borrowing and rediscounting. This is ordinarily less effective in a country such as the United States, where the banking activities are conducted by thousands of individual unit banks, each one of which has relations with a very limited number of the others. There has furthermore been in this country for years a prejudice against interbank

borrowing and rediscounting, which is probably unjustified but is nevertheless an important factor in bringing about a relative lack of mobility in banking funds. This in turn results in wide discrepancies in interest rates in different sections of the country. An open discount market, by furnishing facilities for mobility, would tend to result in a greater equalization in interest rates throughout the country at any given time.

A study of the state of activity in such a market would give a valuable index of the general demand or lack of demand for credit funds at any moment. Additional paper offered in the market would indicate growing business demand for credit, and similarly a diminution of such paper would indicate a falling demand. Such a market would enable the banking funds in the possession of the commercial banks to be fully utilized before recourse was had to the Federal Reserve System. It is a generally accepted theory of central banking that the resources of the central bank, being the ultimate reserve of the nation's banking system, should be extensively utilized only in case of necessity, and the funds of the commercial banks should be utilized in full before the central bank is called upon. In a country of the geographical size of the United States, in the absence of such a market, the situation may frequently arise where banks are borrowing heavily from the Federal Reserve bank in one district, while surplus commercial banking funds exist in another. If the Federal Reserve discount rate happens to be higher than the market rate for commercial funds, this situation is uneconomic as well as contrary to the best central banking practices.

If the open market is participated in by foreign banking institutions, it constitutes a means of controlling the international flow of gold and the state of foreign exchanges. By an increase in the market rate, foreign funds will be attracted and a decrease in the rate will have the reverse effect. Likewise, the purchase and sale in the market of foreign bills may render unnecessary shipments of gold.

Necessary Prerequisites to an Open Discount Market.—As such markets can be developed only in large financial centers, it is necessary to their proper functioning that the banking system furnish facilities for the rapid and inexpensive transfer of funds from one section of the country to another. Any difficulty or considerable expense involved in the transfer of funds from the Middle West to New York or back, would tend to discourage operations in a discount market in New York by a middle-western bank. It is sufficient to mention here that the clearing and collection system of Federal Reserve banks and the operations of the gold settlement fund furnish today a rapid, safe and inex-

pensive transfer of funds which will permit the development of such a market.

An open discount market also depends upon an adequate supply of commercial paper suitable in form for open market handling. The chief impediment to the development in this country of an open market, prior to the organization of the Federal Reserve System, was the lack of such paper. The commercial paper in vogue was almost entirely single-name promissory notes, which are not suitable for open-market handling, except possibly the notes of a few of the larger nationally known business firms. The single-name promissory notes of the many small commercial borrowers would be unsalable in an open market, because of the lack of knowledge of their credit standing. The type of paper most suitable for open-market dealings is bank acceptances, and to a lesser degree trade acceptances. Bank acceptances are a primary liability of banks or acceptance houses whose credit standings are either nationally known or subject to adequate state or Federal supervision. Trade acceptances have the advantage, in comparison with promissiory notes, of being two-name paper, with two commercial houses responsible for their ultimate payment. They suffer in comparison with bank acceptances, however, and with the exception of the trade acceptances of a few prominent houses, do not bulk large in open-market operations.

The Federal Reserve Act authorized national banks to accept time drafts drawn upon them and in this way create bank acceptances, and most of the states have followed suit by passing legislation giving similar powers to state banks and acceptance corporations.

In addition to the existence of suitable commercial paper in sufficient quantities, the creation of an open market is dependent upon the existence of buyers and sellers. Up to the present time, the Federal Reserve banks have been the principal buyers of bank acceptances, and to a slight degree, of trade acceptances in the open market, although the market developing in New York City is being utilized to a larger and larger degree by other purchasers, notably the commercial banks, insurance companies, savings-fund societies, and some private investors. Certain steps taken by the Federal Reserve banks to encourage dealings in bank acceptances have already been noted.

Definition of Open-market Operations.—Dr. Burgess, in his admirable book, "The Reserve Banks and the Money Market," says (page 206):

The term "open-market operations" is used in two different senses. In a broad sense, it is used to signify all those transactions in which the Reserve

banks employ their funds besides their loans to member banks. In this sense, open-market operations include the purchase and sale of bankers' acceptances, of government securities, and of other limited types of securities eligible for purchase. . . . In a narrower sense, the term is used to signify only those transactions in which the Reserve banks ordinarily exercise the initiative, that is, the purchase and sale of government securities.

Open-market Powers of Reserve Banks.—Section 14 of the Federal Reserve Act authorizes the Reserve banks to deal in the open market when it states:

Sec. 14. Any Federal Reserve bank may, under rules and regulations prescribed by the Federal Reserve Board, purchase and sell in the open market, at home and abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers and bankers' acceptances and bills of exchange of the kinds and maturities by this act made eligible for rediscount, with or without the indorsement of a member bank.

Every Federal Reserve bank shall have power:

a. To deal in gold coin and bullion at home or abroad, to make loans thereon, exchange Federal Reserve notes for gold, gold coin, or gold certificates, and to contract for loans of gold coin or bullion, giving therefor when necessary, acceptable security, including the hypothecation of United States bonds or other securities which Federal Reserve banks are authorized to hold:

b. To buy and sell, at home or abroad, bonds and notes of the United United States, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding 6 months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any state, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage, and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board:

c. To purchase from member banks and to sell, with or without indorsement, bills of exchange arising out of commercial transactions, as hereinbefore defined;

d. To establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal Reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business;

e. To establish accounts with other Federal Reserve banks for exchange purposes and, with the consent or upon the order and direction of the Federal Reserve Board and under regulations to be prescribed by said board, to open and maintain accounts in foreign countries, appoint correspondents, and establish agencies in such countries wheresoever it may be deemed best for the purpose of purchasing, selling, and collecting bills of exchange, and to buy and sell, with or without its indorsement, through such correspondents or agencies, bills of exchange (or acceptances) arising out of actual commercial transactions which

have not more than 90 days to run, exclusive of days of grace, and which bear the signature of two or more responsible parties, and, with the consent of the Federal Reserve Board, to open and maintain banking accounts for such foreign correspondents or agencies. Whenever any such account has been opened or agency or correspondent has been appointed by a Federal Reserve bank, with the consent of or under the order and direction of the Federal Reserve Board, any other Federal Reserve bank may, with the consent and approval of the Federal Reserve Board, be permitted to carry on or conduct, through the Federal Reserve bank opening such account or appointing such agency or correspondent, any transactions authorized by this section under rules and regulations to be prescribed by the board.

f. To purchase and sell in the open market, either from or to domestic banks, firms, corporations, or individuals, acceptances of Federal Intermediate Credit banks and of National Agricultural Credit corporations, whenever the Federal Reserve Board shall declare that the public interest so requires.

Summarizing the above section, broadly, it gives the banks authority to purchase and sell in the open market:

a. Gold coin and bullion.
b. United States government bonds and other securities; and certain warrants of municipal and other political subdivisions.
c. Bills of exchange from member banks arising out of actual commercial transactions (with or without indorsement).
d. Bills of exchange arising out of actual commercial transactions, with maturities of not more than 90 days, and bearing signatures of two responsible parties.
e. Acceptances of Federal Intermediate Credit banks, and National Agricultural Credit corporations when Federal Reserve Board so desires.

Importance of Such Operations.—While the act authorizes the Federal Reserve banks to purchase and sell trade acceptances, as well as bank acceptances and certain securities, yet in practice they have not dealt in trade acceptances in any substantial quantity.

The importance of the open-market operations of the Federal Reserve banks should not be underestimated. These powers, together with the rediscount function, if properly used, constitute an effective means for controlling the money market of this country.

Open-market purchases usually rend to reduce the amount of indebtedness of the member banks with the Reserve banks, and enable the former to adopt more liberal credit policies with their customers. It has the effect of lowering interest rates. If the Reserve banks are selling securities, the tendency would be to force the member banks to increase their discounts at the Reserve banks, make their credit policies less liberal, and raise interest rates. The open-market activities of the

Reserve banks therefore tend to make more effective the discount rate changes of the system. In effect, when the Federal Reserve Bank of New York City buys $50,000,000 worth of government bonds in the open market, it not only puts into circulation $50,000,000 worth of credit, but it takes out of the New York market the government securities which otherwise probably would have been absorbed by the commercial banks of that city. So that the effect of the purchase of securities by a Reserve bank in the open market is twofold: first, putting credit in circulation and, second, reducing the amount of securities available for purchase by those institutions possessing loanable funds.

When the New York bank sells securities in the open market, the result is just the opposite. It not only forces a contraction in credit to the amount represented by purchase price of the securities, but in addition it forces the market to absorb an additional amount of securities.

With the large amounts of government securities and bankers' acceptances in circulation at the present time, open-market operations at the Reserve banks can be most effectively used in hastening desired changes in credit conditions.

A very good illustration can be had by viewing the open-market policies of the Federal Reserve banks during the early part of 1928. At that time it was obviously the desire of the Federal Reserve authorities to contract the amount of credit in circulation, primarily because there was some criticism of the vast amount of Federal Reserve credit finding its way to finance stock-exchange purchases. The first week of January, 1928, showed holdings of the Federal Reserve banks consisting of government bonds, certificates of indebtedness, and bankers' acceptances in amount to $627,403,000. Thereafter, the weekly statements revealed the policies of the Federal Reserve banks in disposing of these securities. The table on page 445 indicates the extent of the dispositions:

Lack of Coordinated Policy.—In the years before 1922, no attempt was made to coordinate the open-market activities of the Federal Reserve banks and there existed always the dangerous possibilities that Federal Reserve banks might compete with one another in bidding for the purchase and sale of securities, and that the lack of a uniform policy might lead to the offsetting of the open-market activities of one Reserve bank by the activities of a second Reserve bank holding different opinions concerning the needs of the occasion.

Open-market Committee.—At the annual spring meeting held in 1922 the governors of the Reserve banks appointed a committee consisting of the governors of the Federal Reserve banks of Boston, New

FEDERAL RESERVE BANKS' HOLDINGS.—JANUARY TO MAY, 1928

(In thousands of dollars)

Date	Bills bought, open market	U. S. government			Total government securities
		Bonds	Treasury notes	Certificates of indebtedness	
Jan. 4	$387,131	$293,322	$104,583	$229,498	$627,403
11	392,567	226,765	100,581	217,917	545,263
18	369,035	65,033	243,857	190,478	499,368
25	347,305	56,184	244,266	140,447	440,897
Feb. 1	377,393	61,901	233,082	138,678	433,661
8	369,273	56,443	210,765	134,131	401,339
15	354,787	57,434	213,704	137,295	408,433
21	353,227	55,387	207,741	138,384	401,512
29	343,759	55,610	206,036	145,956	407,602
Mar. 7	338,495	57,047	205,633	140,032	402,712
14	343,326	58,807	193,421	148,659	400,887
21	332,728	57,330	171,767	156,164	385,261
28	346,103	55,711	163,612	166,509	385,832
Apr. 4	343,636	56,233	163,947	163,052	383,232
11	361,595	56,609	151,763	169,644	378,016
18	350,756	56,559	123,124	161,003	340,686
25	365,841	55,237	107,560	141,958	304,755
May 2	363,101	54,880	100,886	136,536	292,302
9	365,104	56,002	101,977	119,413	277,392
16	347,292	54,544	100,417	107,359	262,320
23	330,562	56,528	85,160	88,793	230,481
29	303,988	60,462	65,370	93,594	219,426

York, Philadelphia and Chicago for the purpose of executing the open-market purchases and sales for all the Federal Reserve banks. The following year the Federal Reserve Board appointed an open market investment committee, which, incidentally, consisted of the same members making up the committee appointed by the governors. This committee was charged by the Federal Reserve Board as follows:

That the time, manner, character, and volume of open-market investments purchased by Federal Reserve banks be governed with primary regard to the

accommodation of commerce and business, and to the effect of such purchase or sales on the general credit situation.

That in making the selection of open-market purchases, careful regard be always given to the bearing of purchases of United States government securities, especially the short-dated issues, upon the market for such securities, and that open-market purchases be primarily commercial investments, except that Treasury certificates be dealt in, as at present, under so-called "repurchase" agreement.

In order to provide for the proper administration of the policy defined above, the board rules that on and after Apr. 1, 1928, the present committee of governors on centralized execution of purchases and sales of government securities be discontinued, and be superseded by a new committee known as the open-market investment committee for the Federal Reserve System, said committee to consist of five representatives from the Federal Reserve banks and to be under the general supervision of the Federal Reserve Board; and that it be the duty of this committee to devise and recommend plans for the purchase, sale, and distribution of the open-market purchases of the Federal Reserve banks in accordance with the above principles and such regulations as may from time to time be laid down by the Federal Reserve Board.[1]

Because of the outstanding importance of the New York money market, the Federal Reserve Bank of New York has executed the majority of the orders of this committee.

Open-market Policies.—The open-market policies of the Federal Reserve System have been mainly dictated by credit and business conditions. In times of business recession it is felt desirable to encourage activity and the system buys largely in the open market, thereby making credit easier, with the consequent stimulation of business borrowing; and when credit becomes too easy, with a consequent effect on speculation and prices, it is the policy of the system to sell securities in the open market, which tends to harden credit rates and slow up business borrowing and security speculation.

The effect of the open-market operations of the Federal Reserve banks is more rapid and direct than the effect of their discounting operations. Changes in the discount rate will be effective only if the banks are discounting and the initiation of discounting operations lies with the commercial banks. If the commercial banks are in possession of funds, lowering the rate may not, in fact, stimulate more discounting. On the other hand, the purchase of a substantial amount of paper in the highly centralized and sensitive New York money market would so rapidly increase the quantity of banking funds that cheaper credit would

[1] Stabilization Hearings before the Committee on Banking and Currency, House of Representatives, H.R. 7895, Sixty-ninth Congress, first session, p. 311.

be the almost inevitable result. In the same way, unless the banks were compelled to rediscount, raising the discount rate might be ineffective, but the sale of a substantial amount of securities and paper would absorb funds from the market and compel discounting at the higher rate.

More publicity is attached to rate changes than to open-market operations. Changes in rate are announced as soon as made, but open-market purchases and sales appear only in the weekly statements of condition of Federal Reserve banks.

Before completing a discussion of open-market operations, it is important to keep in mind that American banking practice is unique in being tied up so closely with the stock markets. For many years prior to the creation of the Federal Reserve System, demand loans secured by stock-exchange collateral afforded the only means for commercial banks to secure paper which could be liquidated rapidly, and therefore such loans were regarded as secondary reserves in the portfolios of the commercial banks.

The London money market, unlike the New York, afforded the commercial banks an opportunity for making demand loans to bill brokers upon the security of first-class commercial instruments, but no such agency existed in this country. Since the establishment of the Federal Reserve System, suggestions have been put forward concerning the desirability of building up a group corresponding to the bill brokers of the London market, thereby providing our bankers with an opportunity to make well-secured call loans, on security other than stock-market collateral.

At the present time, no machinery exists which makes it possible for the Federal Reserve Bank to designate the use of funds which it advances to the money market, either through open-market purchases or through rediscounting for member banks. It is true that the rediscounting for member banks is only done upon the security of eligible paper, but the loans, secured from the Federal Reserve banks upon the eligible paper, might be used for stock-market purposes. There is no way of controlling the situation other than for the Reserve banks to refuse to discount eligible paper for those member banks who are heavy lenders to the security markets. The Federal Reserve System must therefore take some cognizance of the state of the stock market, and its discount operations and open-market operations must be governed to some extent by the activities of the securities markets.

Political influences must also be thought of when discussing policies of the Federal Reserve System. Congress, when in session, provides

a forum for all those representatives who desire to make a name for themselves, and since 1919 the Federal Reserve System has been a favored target for such. The activities of the Federal Reserve System, therefore, are consciously or unconsciously influenced by the desire on the part of its officials to avoid unhelpful and often acrimonious debate in Congress.

Before concluding the discussion of the Federal Reserve System, its relations with foreign central banks of issue should be mentioned.

In accordance with the powers granted under Sec. 14 of the act the Federal Reserve Bank of New York has opened accounts with 25 foreign central banks of issue, and certain operations have been undertaken between these banks. These operations can be summarized as follows:

1. Earmarking of gold for the accounts of foreign central banks of issue.
2. The purchase of government securities and of bankers' acceptances for the account of foreign central banks. In making these purchases the Federal Reserve bank guarantees the acceptances and agrees to repurchase the government securities.
3. The sale of foreign bills to the foreign central banks.
4. Agreement by the Federal Reserve bank to purchase, from the foreign central banks of countries returning to the gold standard, acceptances bearing the indorsement of the foreign central banks. (This was done in only one case.)
5. To purchase gold abroad.

As of March, 1930, the Federal Reserve bank has deposits abroad of about $750,000 and has invested in acceptances to the extent of $1,000,000. Foreign central banks have on deposit with the Reserve bank sums totaling $7,250,000, and have invested through the Reserve bank in government securities the amount of $36,000,000, and acceptances totaling $482,000,000. In addition, the Reserve bank has earmarked gold in the sum of $114,000,000.

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CHAPTER XXXIII

SAVINGS BANKS, BUILDING AND LOAN ASSOCIATIONS, POSTAL SAVINGS, LABOR BANKS, PRIVATE BANKERS

Mutual and Stock Savings Banks.—Mutual savings banks are either corporate or non-corporate organizations managed generally by a self-perpetuating board of trustees. The proprietors are the depositors, and in theory the profits are to be distributed among them. In practice, however, the depositors are paid interest on their deposits at a set rate, and the earnings above this rate are accumulated in a surplus fund. If the surplus gets unreasonably large, some additional distribution of profits may be made. This type of savings institution is the only type legally allowed to organize in certain states, as for example, New York and New Jersey.

In the case of stock savings banks or privately owned savings banks, the depositors receive interest at a stated rate, practically always above the prevailing rate paid on checking deposits in the same community, and the profits accrue to the stockholders or owners of the business.

The growth of mutual and joint-stock savings banks is indicated by the figures in the table on page 450.[1]

Pennsylvania Law.—As a typical example of state legislation controlling savings banks, the Pennsylvania law is quoted.

Savings banks may be incorporated in Pennsylvania by any number of persons not less than 13, two-thirds of whom shall reside in the county where the bank is to be located.

Notice of the intent to apply for a charter shall be published in two newspapers in the county once a week for 3 months before the application is made.

The incorporators shall execute a certificate specifying: (1) name of bank; (2) location or place of business of bank; (3) names, residence, and occupation of incorporators; (4) a declaration that each member will accept the responsibilities and faithfully discharge the duties of a trustee when authorized by the act.

Before the charter is granted the auditor-general investigates the local need for a savings bank and the character and fitness of the incorporators.

[1] Report of the Comptroller of the Currency (1928).

Year	Number of banks	Number of depositors, thousands	Deposits of dollars, millions	Average due each depositor	Average per person in the United States
1820	10	8	1	$131.86	$0.12
1830	36	38	6	183.09	0.54
1840	61	78	14	178.54	0.82
1850	108	251	43	172.78	1.87
1860	278	693	149	215.13	4.75
1870	517	1,630	549	337.17	14.26
1880	629	2,335	819	350.17	16.33
1890	921	4,258	1,524	358.03	24.35
1900	1,002	6,107	2,449	401.10	31.78
1910	1,759	9,142	4,070	445.20	45.05
1915	2,159	11,285	4,997	442.83	49.91
1916	1,864	11,148	5,087	456.31	
1917	1,807	11,366	5,417	476.60	
1918	1,819	11,379	5,471	480.79	
1919	1,719	11,434	5,902	516.18	
1920	1,707	11,428	6,538	572.10	
1921	1,601	10,738	6,018	560.44	
1922	1,685	12,539	7,181	572.69	
1923	1,647	13,340	7,898	592.05	
1924	1,603	13,972	8,440	604.06	
1925	1,583	14,657	9,065	618.47	
1926	1,524	15,162	9,599	633.09	
1927	1,461	14,813	9,738	595.19	
1928	1,407	15,004	10,233	608.16	

The bank must organize and commence business within 1 year after the charter is granted, unless the term is extended for a reasonable cause, but the time extension cannot be for a longer period than 1 additional year.

Powers.—Savings banks may hold and convey real estate as follows:

1. Such as shall be necessary for its immediate accommodation in the transaction of its business.

2. Such as shall be mortgaged to it in good faith as security for debts contracted previous to the execution of any such mortgage.

3. Such as it shall purchase at sales under judgments, decrees, or mortgages held by such corporation, or shall purchase to secure debts due to said corporation.

Savings banks may receive deposits in any sum or sums that may be offered, and may invest the same, credit and pay interest thereon. They have the right to limit the aggregate amount that any one person may deposit, and in no case shall this aggregate amount exceed $5,000, exclusive of accrued interest.

Interest on deposits is limited to 5 per cent per annum.

Investments of Savings Banks.—The theory underlying most of the savings-bank legislation is predicated on the assumption that those depositing in savings institutions are incapable of wise selection in a matter of a bank and that the savings group cannot afford to lose their deposits. The savings banks are therefore restricted by legislation, in most of the states, as to the use and investment of the funds secured from their depositors.

As a rule, the laws of the several states restrict investments of savings banks to the following types: (1) government, state, and municipal bonds, including issues made by the agencies of the state, county, or municipality, such as school-district bonds; (2) first mortgages, or bonds secured by first mortgages; (3) railroad, public-utility and industrial bonds; (4) Farm Loan bonds and bonds issued by Joint Stock Land banks.

In some parts of the country, particularly in the South and West, savings banks may invest in commercial paper, while in some parts of the country savings banks may invest in first-class bank stocks.

The portfolio of a well-known savings bank located in Philadelphia discloses the following assets and the proportion each group bears to the total:

Par value	Assets	Cost	Per cent of total
$7,316,000.00	U. S. Government Bonds	$7,300,277.06	10.57
4,978,000.00	State, County, and Municipal Bonds	4,971,650.00	7.20
30,332,200.00	Railroad Bonds	29,155,478.80	42.21
14,439,000.00	Railroad Equipment Trust Certificates	14,254,285.37	20.64
385,000.00	Street Railway Bonds	381,233.70	0.55
3,784,200.00	Public Utility and Miscellaneous	3,668,601.26	5.30
5,505,601.00	Real-estate Mortgages	5,498,923.41	7.96
10,900.17	Call Loans	10,900.17	0.02
610,000.00	Real Estate	610,000.00	0.88
3,223,467.00	Cash	3,223,467.00	4.67
$70,584,368.17		$69,074,816.77	100.00

As typical of the investments included in some of the general fields, the following issues can be cited:

State, county, and municipal bonds:
 City of Nashville, Tenn., Gold Bonds, 1930–1952, 4¾s.
 City of Pittsburgh, Pa., 1942, 4¼s.
 City of St. Louis, Mo., Gold Bonds, 1930–1941, 4¼s.

Railroad bonds:
- Baltimore & Ohio R. R. (Pittsburgh, Lake Erie & West Virginia System Refunding Mortgage), 1941, 4s.
- Chicago Union Station Co., First Mortgage, Series A, 1963, 4½s.
- Long Island R. R. Unified Mortgage, 1949, 4s.
- New York, Philadelphia & Norfolk 4 per cent Stock Trust Certificates, 1948.

Public-utility and miscellaneous securities:
- Lehigh Coal and Navigation Co., Funding and Improvement Mortgage, 1948, 4s.
- Metropolitan Edison Co., First Mortgage Gold Bonds of Series D, 1868, 4½s.
- Philadelphia Electric Company First Lien and Refunding Mortgage Gold Bonds, 1967, 4½s.

Inasmuch as safety is the essence of the investment policy, the banks should have a proper diversity of holdings as well as marketability of a part at least, in order to keep the banks in a liquid condition.

The economic importance of time and savings deposits has been treated in the chapter on the savings department of commercial banks. With the growth and extension of these departments, the savings banks are subjected to increasing competition and the future of savings banks as separate institutions is somewhat problematical.

School Savings Banks.—In some sections of the country, the banks have cooperated with the public schools, in inculcating habits of thrift and saving among the young. To this end, school banks have been established in a number of schools to receive deposits from the school children. In addition, the older children serve in various capacities in the bank and receive practical training in accounting and the other savings-bank activities. Some states have passed legislation correlating these school savings banks with local savings banks. There were, in 1928, 13,835 schools operating savings banks, with deposits totaling $26,005,138.04 received from 3,980,237 depositors.[1]

Building and Loan Associations.—Building and loan associations are private corporations operated on a cooperative basis for the profit of their shareholders. They are ordinarily organized under special legislation in the various states, which gives to them certain exceptional privileges and subjects their activities to certain restrictions designed to safeguard the shareholders' investments. They stimulate saving by collecting small sums, generally paid periodically by their shareholders in payment of their stock subscriptions, or in repayment of their loans from the association, and they aid the shareholders in financing the purchase or construction of homes by lending the sums so collected to the shareholders on mortgage security or on the security of the shareholders' stock. While the general purpose of the loans is to finance

[1] Report of the Comptroller of the Currency (1928).

individual home purchase or construction, the companies are not restricted to loans for this purpose. The profits of the association are not distributed annually but are added to the amounts paid in by the shareholders until the sum of the amounts paid in and the profits equal the par value of the shares. The stock is then said to have matured and is generally paid back to the shareholder.

Importance of Building and Loan Associations.—In Pennsylvania and some other states, building and loan associations constitute the chief source of second-mortgage funds. In other states, they are only permitted to lend on first mortgages and have generally not attained there the same importance. Many borrowers desire first mortgages as permanent encumbrances of their properties, and the amortization features of the building and loan mortgage make it expensive and somewhat unsuitable for first-mortgage financing. Under one name or another, building and loan associations exist in nearly every state in the union, but are particularly strong in Pennsylvania, Ohio, and New Jersey.

Different Types of Association. *a. The Terminating Plan.*—Under this plan, a group of shareholders would organize and issue stock as of the date of organization. The members would subscribe and pay for the stock in small periodic instalments, and the money of the association would be loaned to the members on real-estate mortgage security or on the security of their shares. New members coming in later would have to pay all back instalments on the stock. This feature limited the growth of the association, for the older it grew the more difficult it became to find new members willing and able to pay up the back instalments. Only a few associations operate under this plan.

b. The Serial Plan.—This is also known as the *Pennsylvania plan* and is the one most frequently used. It differs from the terminating plan in that new shares of stock, called "new series," are issued semi-annually or quarterly and the subscribers to these new shares need only pay back to the date of the issue of that series. Each series runs separately and matures in about eleven years. The profits are annually apportioned among the various series.

c. The Permanent Plan.—This plan differs from the serial plan in doing away with special dates for the issuance of each series. New members can come in at any time, each member's shares being treated as a separate series. The advantage of this plan to the shareholder is that he can come in at any time without making any back payment. From the association's standpoint, the plan has the disadvantage of adding to the complication of bookkeeping and the calculation and

apportionment of profits, but it has the advantage of relieving somewhat the problem that faces serial-plan associations when a large series matures. It may be difficult for such an association to procure the necessary cash to pay off the maturing shares; in the permanent plan, shares are maturing continually and in smaller amounts.

d. The Dayton or Ohio Plan.—This is a modification of the permanent plan in that members may pay in on their shares as much as they please at any time, instead of being required to pay specific amounts on periodic dates.

The following description of the activities of a building and loan association will apply to the serial plan, which is the commonest and most popular:

Loans.—Loans are ordinarily made only to members, though it is not necessary that the borrower be a member before he applies for the loan. The security may consist of first or second mortgages on real estate, or the stock of the association. Other forms of security are sometimes permitted by statute, but loans are seldom made on other than the security mentioned. Some states forbid building and loan associations to lend on second mortgages. The applicant for a loan must either own or subscribe to enough shares of the association to fully cancel the debt when they mature. Applications are made on forms supplied by the association and must be submitted to the secretary and accompanied by a nominal fee to pay the expenses of the property committee which examines and reports upon the property to the directors, who pass upon the loan. The property committee makes personal inspection of the premises and a careful appraisal of the value of the property. The examination will be more or less thorough, depending upon the size of the loan and the margin of safety involved. At the regular monthly meeting of the board of directors, the loan is passed upon and accepted or rejected, the recommendation of the property committee being generally followed.

The Premium.—The funds of the association are loaned to the highest bidder, the bids taking the form of a premium which the borrower pays in excess of the usual or legal rate of interest. The amount of the premium will vary, depending upon the state of the mortgage money market and upon the character of the loan itself. Premiums today will run from 10 to 15 cents per share per month on first-mortgage loans, and 20 to 30 cents per month on second-mortgage loans. For example, suppose an applicant desires to borrow $5,000 on a second mortgage. He must subscribe to 25 shares of the stock of the association if the par value of the shares is $200, which is customary,

upon which he must pay $25 a month. In addition to that, he pays interest on the $5,000 at the rate of 6 per cent per annum, which equals another $25 per month, and a premium of perhaps 20 cents a share or $5 a month. The total monthly outlay involved in this mortgage would be $55. The borrower benefits indirectly by the payment of the premium, inasmuch as he is a member of the association and the premiums constitute a profit to the association, in which he shares. If the association has not sufficient funds to meet all the applications, those which cannot be met are ordinarily held over until the next meeting or until there are sufficient funds in the association to permit the loan to be made. The applicant may in such a case withdraw his application and obtain his funds elsewhere, if he does not desire to wait. Associations are not limited in their lending to the money which they receive monthly from their members. They may borrow money to lend, and most associations do so. In Pennsylvania they may borrow up to an amount equal to 25 per cent of the withdrawal value of their stock.

Borrowers sometimes have to pay a commission to procure a loan. This commission does not figure in the association's bookkeeping, for it is not paid to the association but to some director or broker for his influence in procuring the loan. Some associations frown upon this practice and do not permit their directors or officials to receive commissions for placing a loan. However, borrowers may have no knowledge of associations with sufficient funds to meet their needs, and under these circumstances may be willing to pay for information and services which will lead to the procurement of the loan.

Repayment of Loans.—The mortgage is generally written with a maturity of 1 year, but courts have held that the associations cannot compel payment at that time if all the other provisions of the mortgage are carried out. To quote from a recent decision:

> In carrying out the plan on which building associations are organized and conducted, it is not intended that a stockholder who borrows from the association will discharge the debt he incurs by direct payments on account of it. He pays at stated periods the dues on his stock, the interest on the money borrowed, and, when the premium bid for the loan has not been deducted, the instalments on it. When, by the receipt of dues, all the stock of the association or of the series to which the borrower's stock belongs, becomes full paid or matured, the value of his stock equals the amount of his debt, and the transaction is then ended by the surrender of the stock by him, and the cancellation of his obligation by the association.

On the other hand, the borrower may repay his loan in full or in part at any time. When the loan has been repaid by the maturity of

the stock or otherwise, the mortgage is satisfied of record and any other securities the association may hold are returned to the borrower.

National Associations.—Some few associations extend their activities beyond their own state, and solicit membership and make loans anywhere in the United States, through local agencies. Many of them got into financial difficulties and some states have by legislation forbidden their operation.

In some states, corporations doing a business similar to that of building and loan associations operate under other names.

The table on page 457 showing the importance of building and loan associations was taken from the report of the Comptroller of the Currency for 1928.

Postal Savings System.—The United States postal-savings system was created in 1910. For many years prior to that date, attempts had been made to provide a postal-savings system in this country for the purpose of encouraging thrift among the poorer classes by providing a safe place for the deposit of their savings. Such systems were common in Europe and many of the immigrants in this country could not accustom themselves to depositing savings in privately operated institutions. As a result, considerable hoarding was practiced.

Provisions of the Act.—*Administration.*—A board of trustees consisting of the Postmaster General, the Secretary of the Treasury, and the Attorney General supervise the activities of the system. They make the regulations concerning the receipt, transmittal, custody, investment, and repayment of funds deposited at the postal-savings depository offices. The Postmaster General has authority to fix the regulations concerning the deposit and withdrawal of funds, and the designation of the postal-savings banks.

Deposits.[1]—A person desiring to open a postal-savings account should apply at the nearest post office or station, where information will be given. If for any good reason an intending depositor cannot apply personally, a representative may be sent, who will be instructed how to proceed. A person residing at a post office not authorized to accept postal-savings deposits may open an account at a depository office by mail, through his local postmaster, who will give details on application. Any person ten years of age or over is eligible to open an account, provided that person has no open account either at the depository to which he applies or at any other postal-savings depository—in other words, no person may have more than one open account under any

[1] The following material is partially compiled from a circular issued by the Postmaster General and entitled "United States Postal Savings System."

BUILDING AND LOAN ASSOCIATIONS IN THE UNITED STATES *

Number of building and loan associations, total membership and total assets, etc., for the fiscal year ended in 1927, by states

State	Number of associations	Total membership	Total assets	Increase in assets	Increase in membership
Pennsylvania	4,427	1,776,104	$1,245,987,953	$115,987,953	23,896 †
Ohio	827	2,282,603	1,035,429,317	107,047,584	135,418
New Jersey	1,536	1,166,980	886,167,505	126,099,754	82,599
Massachusetts	221	497,220	478,005,147	52,493,828	30,728
Illinois	910	861,000	388,097,831	32,588,530	21,000
New York	313	555,242	349,533,632	51,826,472	51,234
Indiana	404	404,521	274,240,104	26,336,368	22,398
California	191	261,232	241,796,747	51,689,759	37,792
Wisconsin	182	261,685	217,563,993	35,181,620	32,520
Maryland §	1,210	330,000	210,000,000	10,000,000	
Louisiana	105	190,650	174,818,227	20,631,592	25,318
Missouri	251	229,305	159,773,547	20,311,648	14,305
Nebraska	83	235,581	155,213,561	2,085,086	16,774
Michigan	78	206,774	126,799,126	13,911,197	14,704
Kansas	152	194,200	117,979,508	10,664,210	4,807
Oklahoma	89	184,810	116,318,814	12,975,629	17,400
Washington	72	268,404	101,252,277	12,251,114	19,066
Texas	143	145,380	92,632,277	21,827,705	20,429
North Carolina	235	102,000	91,000,000	5,284,991	5,410
Kentucky	151	141,900	85,509,918	10,805,785	8,500
District of Columbia	22	63,768	57,191,666	6,462,392	4,469
Virginia	87	56,300	50,149,670	5,592,474	4,800
Alabama	48	54,700	43,600,944	28,600,944	34,700
Iowa	74	53,049	43,497,008	2,725,441	18,751 ‡
Colorado	62	119,631	42,476,646	7,290,588	34,487
Florida	115	28,500	40,840,280	1,482,555	1,500
Utah	24	92,921	37,251,861	6,387,737	3,363 ‡
West Virginia	60	60,200	36,128,266	7,423,880	5,700
Arkansas	73	58,729	35,830,037	3,800,400	5,665
Minnesota	84	80,956	32,422,622	3,779,414	11,338
South Carolina §	150	28,000	23,000,000	218,000	1,200
Rhode Island	7	34,437	22,635,780	3,097,274	2,618
Oregon	40	44,700	21,913,657	3,633,432	6,500
Connecticut	38	44,504	20,614,415	2,323,518	8,608
Maine	38	29,180	19,549,005	2,090,532	3,009
Montana	30	41,500	16,337,508	2,598,718	4,000
Mississippi	36	21,800	15,417,900	2,402,062	3,200
Wyoming	14	26,123	13,137,453	5,137,453	12,123
New Hampshire	28	16,444	10,397,431	1,173,457	1,329
Delaware	42	17,750	10,212,369	1,368,061	1,500
Tennessee	32	14,775	9,127,109	2,410,892	3,500
North Dakota	19	16,800	8,859,341	1,070,931	1,500
South Dakota	24	7,705	5,497,015	496,588	690
New Mexico	18	7,150	3,833,490	583,490	650
Vermont	10	4,458	2,817,009	580,262	653
Idaho	12	4,700	2,738,752	403,487	450
Georgia §	30	6,500	2,500,000	1,000,000	1,500
Arizona	6	4,400	1,942,019	260,493	475
Nevada	1	900	523,714	63,344	
Total	12,804	11,336,261	$7,178,562,451	$844,458,644	670,556

* Report of the Comptroller of the Currency (1928).

† Decrease over reported estimate of last year; actual increase, 5,576 members.

‡ Decrease.

§ Estimated.

circumstances. The opening of accounts other than personal ones is not authorized by postal-savings law.

After a postal-savings account has been opened, deposits may be made either in person, by a representative, by money order, or by registered mail, if the money-order service is not available. Postal-savings deposits are acknowledged by postal-savings certificates in the denom-

inations of $1, $2, $5, $10, $20, $50, $100, $200, and $500, which are made out in the name of the depositor, serve as receipts, are valid until paid, and are backed by all the strength of the government. These certificates are not negotiable or transferable. If certificates are lost, stolen, or destroyed, new certificates will be issued. Under the present law, no depositor may have to his credit more than $2,500, exclusive of accumulated interest.

Rate of Interest.—Interest accumulates at the rate of 2 per cent for each full year, as long as a certificate is outstanding. It accumulates for a broken, or partial, year at the rate of 0.5 per cent for each full quarter. Compound interest is not allowed, but a depositor may withdraw interest payable and include it in a new deposit, subject to the restriction that deposits will not be received for fractions of a dollar.

Withdrawal of Funds.—A depositor may withdraw all or any part of his funds upon demand, under such regulations as the board of trustees may prescribe. Withdrawals shall be paid from the deposits in the state or territory, so far as the postal funds on deposit (in banks) in such state or territory may be sufficient for the purpose, and, so far as practicable, from the deposits in the community in which the deposit was made.

Withdrawals may be made in person, through a representative, or by mail.

An account may be transferred without cost or loss of interest to any postal-savings depository to which the depositor will move or has moved.

Postal-savings Stamps.—Amounts less than $1 may be saved by purchasing postal-savings stamps at 10 cents each. A postal-savings card with 10 savings stamps affixed will be accepted as a deposit of $1, either in opening a postal-savings account or in adding to an existing account. It may, too, be redeemed in cash at any postal-savings depository office. Postal-savings cards will be furnished free of cost.

Postal-savings Bonds.—Deposits may be exchanged wholly or in part for registered or coupon United States postal-savings bonds, bearing 2½ per cent interest and issued in denominations of $20, $100, and $500. When bonds are issued in exchange for postal-savings deposits, the balance to the credit of the depositor is reduced accordingly, on Jan. 1 or July 1, the effective dates of exchange, as the case may be—in other words, postal-savings deposits, when converted into bonds, are not counted as a part of the $2,500 maximum which one person may have on deposit with the Postal Savings System. The amount of bonds

so receivable in exchange for deposits is not restricted, for the process may be repeated semiannually over and over again. Any time after issue, the board of trustees of the Postal Savings System will purchase postal-savings bonds at their par value, plus accrued interest.

Investment of Postal Savings Funds.—The funds secured from depositors may be redeposited by the postal authorities in the banks of this country, where they must bear interest at a rate not less than 2¼ per cent, and where the banks deposit adequate security consisting of "public bonds or other securities, supported by the taxing power." The funds can also be invested in bonds or other securities of the United States government, "when, in the judgment of the President, the general welfare and interests of the United States so require."

In any case, a 5 per cent reserve fund in lawful money must be kept in the treasury of the United States.

As of June 30, 1928, there were 412,250 depositors in the Postal Savings System, with deposits totaling $152,143,349. The average amount of deposit per depositor was $369.06.[1]

Labor Banks.—Some years ago, a number of the labor leaders of this country conceived the idea of having the labor unions enter the field of banking. It was the thought of these leaders that by pooling the resources of their organizations in banks, they would be able to strengthen their bargaining position in the economic world. It was not the idea of the promoters of this scheme to use the labor banks in ways differing from the customary methods of conducting commercial banks. In other words, labor banks as such are not peculiar institutions in any way other than that their stock ownership rests mainly in the hands of labor unions.

The first bank of this type was organized by the International Association of Machinists and was called the Mount Vernon Savings Bank of Washington, D. C. It was soon followed by that of the Cleveland Brotherhood of Locomotive Engineers Cooperative National Bank, organized by the Brotherhood of Locomotive Engineers. Similar institutions were organized in other cities.

On the whole, the operation of these banks has not been very successful, and most of them have either liquidated or have been absorbed by other banks.

Private Bankers.—The *private bankers* in the United States may be divided into three groups, two of which may be considered together. First those whose operations and activities are international in scope

[1] Report of the Comptroller of the Currency (1928).

and second those who do a national and frequently a comparatively local business. In the first category would appear such houses as J. P. Morgan & Company; Kuhn, Loeb, & Company; Dillon, Read & Company; and others. In the second group, the many smaller local houses would be included. These two groups of investment banking houses engage in a business consisting of banking, though receiving comparatively few deposits, foreign exchange, the promotion and underwriting of enterprises, and in many cases a stock-brokerage business.

The importance of these organizations in the financial system of this country is very great. In several cases, these houses practically control large commercial banking institutions, and have access to great resources. Since the World War they have exerted considerable influence in practically all of the money markets of the world. European governments frequently turn to the private banks of this country for necessary financial assistance. J. P. Morgan & Company acted as the fiscal agent for several of the European powers, and at the present time is serving as the American representative in the financing of the New International bank. Morgans serve along with the Bank of England, and other central banks of Europe in this work.

The third group of private bankers consists of those few houses that engage in a so-called commercial banking business, receiving deposits and making loans. They operate chiefly in foreign sections of the large cities, and are not subject to as strict regulation as are the corporate commercial banking institutions.

Practically all private banks are partnership or proprietor organizations, and thus are enabled to perform functions denied corporations subject to corporate law. Some of the states, however, have recently subjected the private bankers to some degree of supervision, and many of them voluntarily report to the Comptroller of the Currency.

Typical of state supervisory legislation is the Pennsylvania law.

In Pennsylvania the business of private banking is regulated by the Act of June 19, 1911, P. L. 1060. The important provisions of that act are as follows:

1. Except as hereinafter provided, no individual, partnership or unincorporated association shall hereafter engage, directly or indirectly, in the business of receiving deposits of money for safe-keeping or for the purpose of transmission to another, or for any other purpose, without having first obtained a license from the Commissioner of Banking. To obtain the license the applicant shall file a written statement showing:

a. Amount of asset and liabilities of applicant;

b. Place of business;

c. Names and addresses of partners or members;

d. That applicant is a citizen of Pennsylvania; or

e. In the case of a partnership or association, that a majority of the members having a controlling interest in the business are citizens of Pennsylvania.

The applicant shall also deposit with the Commissioner of Banking a bond with sureties, in an amount not over $50,000 nor less than $10,000 to secure the proper conduct of the business. In lieu of the bond, the Commissioner of Banking may accept money or securities in the form of bonds of the United States, of the state of Pennsylvania, or any municipality thereof or other securities approved by the board in an amount equal to the bond.

The applicant shall be examined; the application shall be published over a week for 3 weeks in two newspapers of general circulation and a legal periodical in the county where business is to be conducted, or nearest county where such newspapers are published. If examination is favorable, license is issued upon payment of a fee of $50.

The license shall be conspicuously posted and displayed on business premises.

The bond or securities above mentioned shall be held as a trust.

2. Such private bankers shall keep books of account, and complete records of all business; and shall, at least twice a year, upon written notice from the Commissioner of Banking file a statement under oath of assets and liabilities; a copy of which shall be published three times in a newspaper of general circulation and a legal periodical, if any, in the county where business is conducted or in the nearest adjacent county.

The license may be surrendered and business discontinued upon proper advertisement.

3. Criminal penalties are provided for violations of the provisions of the act; making false statements; failing to file reports, etc. . . .

8. The provisions of the Act shall not apply to

a. Corporations or national banks;

b. Any hotel keeper who shall receive money for safe-keeping from a guest;

c. Any express company or telegraph company receiving money for transmission, provided such company is not engaged directly or indirectly in the sale of steamship tickets;

d. Any individual, partnership, or unincorporated association which in a city in the first or second class shall file a bond or give securities in the sum of $100,000; and elsewhere in the state, of $50,000;

e. Brokers, holding a membership in a lawfully incorporated brokerage exchange, and doing only such banking as shall be incidental to such brokerage business;

f. Any private bankers now engaged in business (1911) which shall continuously and in the same location have conducted the business of private banking for a period of 7 years prior to the passage of the Act.

Supervision over such bankers as are included in the above act is vested in the Department of Banking.

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CHAPTER XXXIV

COMMERCIAL PAPER HOUSES, MORTGAGE COMPANIES, FINANCE COMPANIES

Commercial Paper Houses.—Commercial paper houses, sometimes called *note brokers,* engage in the business of dealing in commercial paper. They may act simply in the capacity of brokers between the makers of commercial paper and the purchasers thereof, but more frequently they buy the paper outright from the makers and then sell it. They purchase the paper from business houses who need working capital, and sell the paper to banks and other investors who have capital to lend. They constitute, therefore, an important agency in the mobility or flow of funds from those areas possessing a surplus of capital to areas in need of funds.

In addition to this primary service, their activities tend to result in a geographic equalization of interest rates throughout the country, although this is only a tendency, and complete equalization does not exist. They aid in the establishment of an open market for commercial paper, and their credit investigation and credit requirements probably raise the business standards of those firms raising working capital from this source.

Organization.—The commercial paper houses are generally partnerships rather than corporations. Corporations cannot acquire membership in stock exchanges; partnerships are less hampered by state requirements controlling corporations; and the chief risk attached to partnership organization, namely that of unlimited liability for the debts of the firm, is relatively unimportant, as the commercial paper houses in this country do not indorse and so guarantee the paper they sell.

Most of the commercial paper business of this country is done by fifteen large commercial paper dealers who usually have a central office with several branches, the popular locations of central offices being New York and Boston, while the branches are located in those cities in which industries lending themselves to the commercial paper business are centered.

In some cases, commercial paper houses will employ correspondents rather than use branch agencies. This, of course, reduces the overhead cost and tends at the same time to increase the extent of territory which the business can serve.

The types of business enterprises using commercial paper houses have determined to some extent the location of the several offices, and therefore the commercial paper offices are located in those sections of the country adjacent to the location of the borrowers; and at the same time chief offices are usually located in those centers convenient to banks possessing funds which they expect to invest in commercial paper.

The following list indicates the larger centers in which are located two or more branches of commercial paper houses:

Boston	Scranton	Detroit	San Francisco
Hartford	Atlanta	Chicago	Los Angeles
New York	Pittsburgh	Minneapolis	Portland
Philadelphia	Cleveland	St. Louis	Seattle

Commercial paper houses, in addition to the commercial paper business, often have other interests, such as the handling of securities, syndicate participation, etc. The commercial paper business is seasonal in nature, particularly in one-crop agricultural sections. Such sections buy considerable paper after the crop has been moved. The difference in time in seasonal peaks in different sections of the country is a factor of great importance in this business, enabling the commercial paper houses to buy paper in one section and sell it in another with profit.

The very existence of commercial paper houses is largely dependent upon geographic differences in interest rate occasioned largely by the lack of perfect mobility of funds. Our unit banking system has therefore facilitated the growth of the commercial paper business. In Canada, for example, where an extensive system of branch banking provides free mobility of funds from one section to another and tends to a geographical equality of interest rates, there is no field for commercial paper houses to operate, as their profit in buying and selling depends upon a spread in rates.

Types of Paper Dealt In. *a. Form.*—Unsecured single-name promissory notes represent probably more than half of the portfolios. They are generally made payable to the order of self and then indorsed. They can thus be negotiated without indorsement and guaranty of the commercial paper houses.

A small proportion of the notes sold are double-name promissory

notes, some trade-paper, that is, notes given by the purchaser of goods to the seller, and some non-trade paper, which differs from single-name paper only in containing the indorsement of some officer or director of the issuing corporation or some member of the firm. Occasionally, commission houses indorse the paper of textile mills for whom they sell.

Some few of the notes are secured by collateral consisting of stocks or bonds, warehouse receipts, or chattel mortgages on cattle. A few trade acceptances will occasionally appear in the portfolios, and bank acceptances represent a type of paper growing in popularity and appearing in portfolios in increasing quantities.

b. Maturity.—Most of the paper dealt in has a maturity of from 3 to 6 months. In special cases it may be as low as 30 days and as high as 9 months. The paper is very seldom renewed. From the standpoint of the purchaser, however, maturing paper will often be replaced by new issues.

c. Denominations.—Customary denominations range from $2,500 to $10,000, $5,000 being the popular figure. Some higher denominations are reported, generally $25,000 and $50,000, although there have been instances of paper in $500,000 and even $1,000,000 denominations.

Rates.—The paper as a rule bears no rate of interest. Instead, it is sold at a discount, with rates varying with the locality, state of the market, and character of the paper. The rate at which the commercial paper house purchases the paper from the maker is generally lower than the bank rate of discount in the same area. The commercial paper houses charge from 0.25 to 0.5 per cent commission for handling the paper, in addition to which they make a profit by selling the paper at a lower rate of discount than their purchasing rate. Occasionally, however, they do not buy the paper outright, assuming the risks of marketing it at a profitable rate, but sell it on a commission basis alone.

Borrowers.—Most of the businesses obtaining working capital by selling their paper to commercial paper houses, in the *open market* as it is called, are large and nationally known concerns. There would be little market for the paper of the small local business man. All types of business enterprises are represented. Many concerns borrow for seasonal purposes, some few borrow continuously, in many cases alternating between the banks and the commercial paper houses, borrowing from the banks to pay off maturing *open-market* paper, and borrowing in the *open market* and from its bank at the same time.

Purchasers.—The banks are the chief purchasers of the paper. The city banks buy on their own account and for the account of correspondents as well. Large quantities of paper are also sold directly to

country banks as well. In addition, corporations, insurance companies, and private investors buy relatively small quantities.

The paper is generally sold on option, the purchasers being allowed some days for credit investigation. During the option period the paper may be returned. Paper is paid for, when delivered, by cashier's check or bank draft, and if the paper is returned during the option period, the necessary adjustment and return of the purchase price are made.

Financing.—The margin of profit in handling the paper is small, and in consequence a rapid turnover of capital is necessary for substantial profit. In addition to the capital of the commercial paper house, extensive borrowings from banks are common, amounting sometimes to several times the capital of the borrowing house. The collateral is ordinarily commercial paper which the house holds, though stocks and bonds are sometimes used.

Advantages to Borrowers.—The borrower whose paper is to be sold to banks by the commercial paper houses must have good financial and business standing, good banking connections, favorable financial statements and good credit reputation, unquestioned integrity, substantial capital, and fair earnings. It is claimed by some that these necessities for open-market borrowings have improved business methods. Contact with a good commercial paper house will place at the borrower's service the experience and advice of the broker in improving his financial policy and strengthening his credit.

It enables borrowers to raise capital outside of their local community and so permits an expansion which might have been handicapped by the limited resources of local banks. This is particularly true when large industries are located in relatively small communities where the unit banks are small, and restricted in addition by national or state laws limiting the size of loans to individual borrowers. The extension of branch banking may diminish the importance of this argument in the future.

Even where the banks are adequate in size to supply the borrower's need, open-market borrowings from time to time will enable borrowers to clean up their loans at the banks at frequent intervals and so improve their credit standing at the banks. It will make continuous borrowing from the banks unnecessary.

The rates charged by banks for loans are largely the result of local monetary conditions. Commercial paper houses, with nation-wide organization, can sell the paper where funds are plentiful and rates are low, so that they can ordinarily give to the borrower the benefit of rates lower than those charged by the local bank. In addition to a

lower rate, the borrower gets the use of the entire proceeds of his loan, while banks will frequently require balances of from 10 to 20 per cent of the amount of the loan during its life.

It is claimed that the frequent credit investigations made of the borrower by potential purchasers of his paper will enhance his credit position and enlarge his reputation and standing. In addition, the wide sale of his paper may have some advertising advantage, make his earnings and credit a matter of widespread knowledge which will be of advantage in case he wishes to expand his permanent capital, and, to that end, offer investment securities to the public.

Disadvantages to Borrower.—Some of the foregoing advantages may be open to question. Although the commercial paper house may advance the entire proceeds of the loan and require no deposit balance as do banks, still, the deposit balance cannot be dispensed with by the borrower, as, to maintain his credit standing as a basis for the sale of his paper, he must show a favorable cash position, with substantial bank balances.

It is claimed by some bankers that in the long run borrowers using the open market do not benefit in the matter of rates. To continue in business, the commercial paper houses must sell the paper they buy at a profit. If the rates throughout the country are not favorable for this, they do not buy, and the borrowers are forced back to their banks for accommodation. The banks may then charge these borrowers a higher rate than the average rate charged the regular customers, who have stuck to the banks instead of taking advantage of the lower rates offered at certain times by the commercial paper houses. It is doubtful, however, whether the facts will justify this contention.

Many businesses do not like to subject themselves to the numerous credit inquiries that will result from offering their paper on the market.

There have been instances in which the borrowers have had simultaneous recourse to banks and the open market for credit, the open market thus forming a temptation and an avenue for overexpansion and overextension of credit.

Advantages to Banks.—Commercial paper marketed by commercial paper houses is an admirable instrument for the surplus funds of banks. In this way banks may diversify their loans both geographically and by industries. Small country banks particularly often find local loans unliquid and frequently renewed, and there is the risk of depression in the local industry, which could be partially offset by the investment of a portion of the bank's resources elsewhere.

Commercial paper bought in the open market is almost never

renewed, ordinarily has a high credit standing, is generally eligible for rediscount, and so is more liquid than bonds and because of short maturity less liable to fluctuation in principal value, which might result in loss. In the matter of rediscount, many local borrowers object to having their paper rediscounted, as it may interfere with renewals.

Bankers may pick out from the list of paper offered by a commercial paper house maturities that will meet the bank's requirements, whereas, in local loans, maturities must frequently be made to meet the borrowers' requirements. Bankers in this way can invest surplus funds for 10 days or 3 months, as they see fit. Again, losses on purchased paper are generally lower than on local loans.

Disadvantages to Banks.—While the advantages unquestionably outweigh the disadvantages, the reverse of the picture should be shown. Bankers generally get a lower rate of return on open-market paper than on straight loans. In some cases, the bankers see their good borrowing customers turn to the commercial paper houses, and the bankers are then forced to buy their former customers' paper at a lower rate. Also, straight loans result in increased deposits, whereas the purchase of paper does not.

It is claimed by some that although the commercial paper houses tend to make interest rates more uniform geographically, still, over a period of time, they cause wide fluctuations in rates. They are alternately in and out of the market, as conditions, from the point of view of profits, change; and the banks must shoulder the burden and advance the necessary credit when the commercial paper houses are not active.

Mortgage Companies.—There are various types of companies that engage in the business of lending money on mortgage security and then selling to the public, with or without the company's guaranty, bonds or certificates representing fractional parts of the mortgage. This business is growing rapidly in importance, and such companies play a large part in property development, particularly in the construction of large apartment houses, hotels, and office buildings, though, in addition to their building loans, they also lend on properties already constructed, including store properties and residences. Their activities are based upon the theory that real estate constitutes one of the best securities for loans and that the investing public will freely buy mortgages provided they can be procured in amounts within the reach of the average possessor of a moderate income. If a $1,000,000 mortgage is needed on an office building, it is obvious that the number of trust estates or banks or insurance companies that could handle a single mortgage of that size is limited, but if that $1,000,000 mortgage can be split up into

fractional bonds or certificates in denominations of $500 or $1,000, the funds can be ultimately supplied by some hundreds of small investors.

Some of the companies issuing such mortgage bonds do not guarantee them, the purchasers relying upon the reputation of the mortgage company for sound and conservative lending. One such company advertises that purchasers of its bonds for over forty years have never lost a cent of their investment. Other companies guarantee the bonds they sell, the value of the guaranty depending upon the capital, surplus, and reserve of the company. Such companies ordinarily advertise the fact of their guaranty by calling themselves mortgage guaranty companies. Certain of these companies, in addition to guaranteeing the interest and principal of the mortgage bonds they sell, will, for a small commission, guaranty mortgages they do not take, but which, with their guaranty, can be more readily placed elsewhere.

The mortgage company collects and pays to the bondholder the interest when due, and the principal at maturity; acts for the bondholders in the foreclosure of the mortgage in case of defaults; and during the life of the mortgage takes care of all such details as ascertaining that the taxes on the property are promptly paid and that adequate fire insurance is maintained. This is a great convenience to the purchasers of the bonds, who get all the advantages of mortgage security without any of the trouble attendant thereto. For these services, the mortgage companies receive a rate of interest on the mortgage at least one-half of 1 per cent greater than the rate paid to the holders of the bonds, and, in addition, may receive a commission which will vary with the condition of the mortgage market, the risk attendant upon the particular loan, and the amount of service rendered. For example, a larger commission will generally be paid for a building mortgage because of the large additional number of details attendant upon such a mortgage, in comparison with a straight mortgage on a complete building.

So successful has been the selling of fractional parts of larger mortgages that banks and trust companies, as well as mortgage companies, will sometimes adopt the same procedure.

Plan of Operation.—The procedure involved in making a large loan will here be briefly reviewed.

a. Application for Loan.—The application for a loan must be made at the outset by the prospective borrower on a blank on which detailed information is asked for regarding the borrower's financial condition and the real estate that he contemplates mortgaging. The information on the application will be checked up and verified by the lending company, the chief purpose of the application being to establish a

starting point for the investigation. In addition to the information given in the application, the applicant should be fully informed upon all business details surrounding the loan so that they can be clearlv explained to the officers of the lending institution.

b. Legal Procedure.—The loan application goes to the legal department where the debt is created (represented by notes or bonds) and the security (represented by a mortgage or deed of trust) is pledged.

Where the security offered is a completed building, the matter resolves itself into the drawing up of the note and the mortgage, care being exercised that the mortgage carries a full description of the property and the conditions under which the covenant is made, as well as the covenants binding upon the mortgagor and the provisions for default.

When the loan is made for the purpose of constructing a new building, a different type of agreement must be entered into, one that will cover the disbursement of funds as they are advanced under the mortgage for the construction of the building. It is usually customary for the mortgagor or the borrower to provide funds sufficient to carry the cost to a point where the funds of the mortgagee or the loaning company will complete it free from mechanic's liens or claims for labor and materials.

c. Bonds and Deeds of Trust.—After this agreement has been completed between the parties, the bonds and deeds of trust are prepared. The latter, carrying almost the same provisions as are enumerated above, as well as any other provisions that might be necessary to protect the bondholders, is then executed, delivered to the trustee, and recorded, and this agreement is afterwards the guide in making disbursements and issuing bonds.

Finance Companies.—There are in the United States a considerable number of corporations engaged in somewhat similar financial activities, under a variety of names, such as finance companies, credit companies, discount companies, etc. They engage in the business of advancing funds to companies who wish to discount their open-book accounts or notes or acceptances received as a result of commercial transactions. Some of these companies extensively aid in the financing of the automobile industry, either by advancing funds to dealers to enable them to purchase automobiles, or by advancing funds to finance the retail sale of automobiles, generally on the instalment plan. In addition to automobile financing, some of these companies also finance extensively the instalment sales of other commodities, such as furniture, musical instruments, refrigerators, household utilities, agricultural implements, etc.,

and occasionally some of the companies may advance funds against the security of merchandise.

Those companies which specialize in the discounting of accounts receivable are called "discount companies."

Discounting Receivables.—Most commercial banks refuse to discount accounts receivable for their commercial customers, and the discount companies have arisen to specialize in this phase of the banking business. The receivables discounted are generally open-book accounts—notes and acceptances playing a smaller part, as these are customarily discountable at a bank. In the discounting of accounts receivable, the account is assigned to the finance company and thereafter the finance company may or may not notify the debtor that the account has been so assigned. From the standpoint of the firm discounting its receivables, the non-notification plan is preferable. As few companies like to have their customers know that their financial condition requires the assigning of their accounts receivable, it is frequently interpreted as an evidence of financial weakness. From the standpoint of the discount company, however, the notification plan is safer. For if the debtor is notified of the assignment he is thereafter required to pay his account direct to the discount company. In the case of non-notification, the account is paid to the company which has sold the account, and the discount company is to some extent dependent upon the integrity of the seller in forwarding remittances. Trust relationship is here established, the seller receiving the collections as trustee for the discount company, but there have been a considerable number of instances of failure to remit.

Discounting Procedure.—The discounting of each account receivable is not considered as a separate process. Generally a contract is signed between the seller and the discounting company, providing for the discounting of receivables up to a certain amount, and setting forth in considerable detail the terms and conditions under which the discounting is made. This contract among other things specifies what percentage of the accounts will be advanced by the discount company. It is customary for the discount companies to advance about 80 per cent of the face value of the accounts. This margin is made necessary by the fact that some of the accounts will not be paid, others will be paid only in part, concerning some there may be disputes as to the accuracy of the amounts charged in the books of the seller, and in some cases there may be returned goods bringing about modifications in the account.

Under the terms of many of the discounting contracts, this 20 per

cent margin, after being collected, is returnable to the seller, only when all accounts between the seller and the discount company are satisfied in full, the collected margins being thus additional security for excess discounting in uncollected accounts.

The contract specifies either that the debtors are to be notified of the assignment by the discount company or in case of non-notification that the discount company shall have the right at all times to inspect the books and records of the selling company to ascertain whether or not the accounts have been paid. And a further provision that the seller shall transmit when received, all checks, drafts, notes, etc., in payment or on account of any accounts which have been sold to the discount company.

The contract gives to the discount company the necessary power to indorse checks, drafts, notes, etc., received on the accounts, with the assignor's name; the contract makes an actual assignment of the accounts conveying title to the discount company, listing each account separately; and, finally, the contract specifies the charges and times of payment on the part of the seller.

The company selling the accounts guarantees the payment and in addition the personal guaranty of officers or directors of the seller may be required; likewise, a fidelity bond may accompany the contract, to assure a proper remittance of accounts collected by the assigning company.

Credit Investigation.—Because the seller guarantees the payment of the assigned receivables, a credit investigation of the seller should be made, including a filing and analysis of the seller's financial statement.

Overdue Receivables.—Some proportions of the receivables discounted are ordinarily not paid when due. The discount companies generally carry these overdue receivables for a limited period of time and then require the seller to repurchase them or substitute other receivables in their place.

Discount Company Charges.—Charges range from 1 to $1\frac{1}{2}$ per cent per month on the net flat amount of receivables purchased with an additional flat charge for investigation, auditing, etc., and an occasional premium charge for fidelity bond. As the seller receives only 80 per cent or less of the face value of the receivables, the actual cost to him is considerably higher than these figures alone would indicate. Most of the companies do not, as above stated, reimburse the seller the amount of the margin when the accounts are paid, but hold those margins as additional security for unpaid accounts.

Discount Company Financing.—The discount companies are corporations and obtain substantial capital by the sale of their own securities in the form of common and preferred stocks and bonds. In addition, they borrow considerable sums from the banks and in some instances obtain working capital through the open market. A common method of borrowing is the sale of collateral trust notes, the collateral consisting of discounted receivables deposited with the trustee. As the receivables are paid, new receivables are substituted and the collateral trust notes are generally serial notes with fairly rapid maturity dates. The banks furnish a considerable proportion of the capital of the discount companies, either as a result of the purchase of collateral trust notes or as direct loans. The discount companies thus practically act as a guarantor in discounting the receivables of business firms and serve as a buffer between these business firms and the banking systems.

Auto Finance Companies.—Discount companies may engage in the wholesale or retail financing of automobiles, or, as is frequently the case, separate companies specializing in that type of finance may be created. Those companies engaged in wholesale automobile financing will advance from 80 to 90 per cent of the wholesale price of the cars to dealers to enable them to purchase the automobiles from the manufacturer. Somewhat less than this may be advanced for the wholesale purchase of trucks. In the majority of instances, the automobile dealer gives his note or acceptance to the finance company, accompanied by a warehouse receipt or a chattel mortgage on the cars. In some instances, the finance companies purchase the cars and give to the dealers a repurchase option.

As the cars are sold by the dealer, the notes or acceptances are redeemed. These dealer notes may be discounted with banks or accepted as collateral security for the issuance of collateral trust notes with which the finance company raises a part of its capital.

Retail Financing.—A smaller percentage is advanced in retail financing than in wholesale, partially because in the first place the retail price of the car is the basis of the consideration and partially because the legal details involving security are more difficult in the matter of retail finance. A conditional balance of sale, lease agreement or chattel mortgage, may be used for the protection of the finance company, depending upon the laws of the state in which the transaction occurs. The lease is a frequently used plan, and under that the retail purchaser rents the car, title remaining in the finance company, paying rent, therefore, for a stipulated period of time, after which the car becomes the property of the lessee. The lessee agrees to properly house the car,

repair it, keep it in condition, to notify the lessor of loss resulting from fire, theft, or collision, and to keep the motor vehicle free from all liens, or encumbrances of any nature. The obligation to pay rent is generally embodied in a single note, with a schedule of payments specified, or in a series of notes for each instalment. The lessee is required to carry adequate insurance to guard against fire, theft, and personal and property damage. The cost of such financing to the purchaser is generally in the neighborhood of 15 per cent, the instalment payments being spread over a period generally not in excess of one year.

The automobile finance companies obtain their capital in ways similar to the methods hitherto discussed for discount companies.

Other Instalment Finance.—Numerous commodities other than automobiles are purchased on the instalment plan and are financed by methods roughly analogous to automobile finance methods. The purchaser is given possession of the property purchased to either a conditional sale agreement, lease, or chattel mortgage, depending upon the legality of these methods to state laws. Payments are made by instalments, which are frequently embodied in the form of notes maturing at periodical intervals. The finance companies discount the notes, to enable the dealers to get back their capital, and the finance companies in turn rediscount the notes with banks, or use them as collateral security for the issuance of collateral trust notes.

Economic Service of Finance Companies.—Finance companies perform a valuable economic service in providing funds for individuals or companies who cannot fulfil the usual requirements of the commercial banks, and who need a longer time for repayment than the commercial banks can ordinarily extend. Then, commercial banks are not ordinarily equipped to attend to the repayment of loans in small periodical amounts, unless they have a personal-loan or industrial loan department.

Again, this business could not be carried on by banks at the customary legal rate of interest, and an effort by the banks to impose higher rates upon this class of customer may lead to dissension among borrowers. Finance companies, however, dealing with this type of customer alone can make the higher charges without running the risk of dissension. Specializing as it does in this type of risk, the finance company can make more detailed investigation and protect itself better than could the commercial banks handling this business, along with a heavy volume of other activities. The success of the finance companies indicates the importance of specialization in this field of finance.

From the consumer's point of view, the auto finance and instalment finance companies have brought within the reach of the steady wage-

earner certain necessities and luxuries, the acquisition of which would have been impossible under any usual system of banking accommodation.

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CHAPTER XXXV

INDUSTRIAL FINANCE COMPANIES, MORRIS PLAN BANKS, INVESTMENT TRUSTS, EDGE ACT CORPORATIONS

The theories underlying the granting of small character loans to deserving wage and salary earners were discussed in the section of this book devoted to the personal loan department of a commerical bank, and it was pointed out that personal finance or industrial finance, as it is frequently termed, fills a growing need in the complex social organization which has evolved during the past two decades.

It was not until 1908 that serious efforts were made to place the personal loan business on a high plane. Before that time, if the wage earner desired to borrow credit for legitimate needs, such as the payment of bills resulting from sickness, death, or some other unfortunate happening, he was compelled to go to private organizations or individuals, who would often charge a prohibitive rate for the use of small sums. Because of the usurious rates charges, the professional money lenders engaged in extending that type of credit were popularly designated loan sharks, and the business was not regarded favorably.

Professional Money Lenders.—Professional money lenders are of several types. First, and probably oldest in point of origin, is the pawnbroker, who extends credit to the needy by purchasing personal property at a ridiculously low figure and agreeing to sell it back within a specified time at a substantially higher figure. The difference between the purchase and the sale prices represents the profit made by the pawnbroker, and corresponds to an interest charge. As far as the borrower is concerned, the cost of obtaining the loan is excessive, and often runs as high as 100 per cent per annum.

The second type of money lender is the chattel loan broker who lends credit on the security of personal property of the borrower, such as household effects, automobiles, or the like.

The third type of professional money lender is the salary loan broker who extends credit upon the security of an assignment of wages of the borrower or, if it is desired to evade the usury law, the salary loan broker might purchase the salary of the borrower.

Needless to say, any one of the three above-enumerated methods for extending credit to the wage earners places an unfair burden upon the borrower, because of the opportunity for the lender to charge exorbitant and usurious rates of interest. It was not uncommon to find a borrower in a position of borrowing \$100 or \$200, and being compelled to pay interest of from 50 to 1,000 per cent.

Industrial Finance Companies.—Agitation appeared at various times for the amelioration of the condition of the borrowing wage earners, but it was not until 1908 that the Division of Remedial Loans of the Russell Sage Foundation of New York City undertook a national survey of the personal lending field. This survey found that unwholesome conditions existed, although the fact was recognized that interest rates charged the small borrower would have to be in most cases substantially higher than the rate charged the large borrower by the commercial banks of the country. As a result of their findings, the Borrowers' Uniform Small Loan Act was formulated by the Russell Sage Foundation, and agitation was started in the several states to secure the passage of laws based fundamentally upon this act, but modified to meet the specific needs of particular states. Up to the present time the essential features of this act have been incorporated into the laws of the following states: Maine, New Hampshire, Massachusetts, Rhode Island, New York, Connecticut, New Jersey, Pennsylvania, Maryland, Virginia, Georgia, Ohio, Indiana, Illinois, Michigan, Iowa, Nebraska, and Arizona.

The passage of these laws by the several states encouraged the entry of corporations with substantial capital resources into the industrial finance business. Today several large chains exist with offices located in the principal cities of the United States. These *industrial finance companies*, so called because they extend credit to the wage earner, are operating in a growing field and one which, if properly administered, yields substantial profits, because of the high interest charges allowed by the Uniform Small Loan Act.

Uniform Small Loan Act.—This act provides, in effect, that any person, partnership, or corporation in this state, desiring to loan money in sums of \$300 or less, either with or without security, to individuals pressed by lack of funds to meet immediate necessities, may obtain a license to conduct such a business from the Banking Commissioner. The cost of such a license is \$50 per year.

The Banking Commissioner may refuse to grant the license for cause, and may revoke the license for violations of the provisions of the act. In addition to the license fee, the applicant must pay the cost

of an examination by the Banking Commissioner and must file a bond in the sum of $5,000 for the faithful observance of all laws relating to the business. A separate license must be obtained for every place of business, and the license must be posted at the place of business in a conspicuous place.

Those doing business are subject to examination by the Banking Commissioner at least once a year, or oftener, if deemed necessary, the license to pay the cost of the examination.

Those obtaining such a license may lend sums not in excess of $300, with or without security, and charge therefor interest at a rate not to exceed 3½ per cent per month. No other charges may be made or collected under any pretext whatever. Interest shall not be payable in advance or compounded and is payable only on unpaid balances. If charges in excess of this are made and collected, the borrower may recover them, and is only liable to pay thereafter the principal of his loan, plus interest on unpaid balances at the rate of 6 per cent per annum. The borrower in such a case may recover in addition a $50 penalty from the license.

This law does not relate to banks, trust companies, building and loan associations, or pawnbrokers.

At first glance, a 3½ per cent monthly charge appears to be an excessive amount, but a large part of the rate paid by the borrower to the lender is utilized in paying for the expenses necessary to protect such loans. Operating expenses, advertising, bookkeeping, collection expenses, investigating expenses, setting aside a reserve for losses, etc., take up a substantial part of the interest charge.

The loans made to wage earners under this law are limited in amount to $300, and less, but in practice they usually run smaller than the maximum amount allowed under the law, averaging about $100. In states in which chattel loans are legal, such security may be required, while in some states an indorsement is all the security necessary, and most companies will take the indorsement of the wife on the note of a husband.

The methods of investigation of the borrower, the type of borrowers, the uses to which the funds, secured from the loans, are put are similar to loans made by the personal loan departments of commercial banks, and by the Morris Plan institutions. In view of the fact that such matter has been discussed in the sections devoted to those institutions, additional discussion does not appear necessary here.

The question is often raised as to the justice in charging the small borrower a rate of interest so much higher than that charged the large

commercial borrowers. Walter S. Hilborn, formerly acting director of the Division of Remedial Loans of the Russell Sage Foundation, states, in a pamphlet, his reasons for this additional charge as follows:

1. The risk on these loans is relatively greater, the duration of the loan being longer than in the case of ordinary bank loans, generally 12 months, and the security of a character not usually acceptable to a commercial bank.
2. Operating expense is high because the amount of each loan is small, it must be collected in monthly instalments, and investigation of the reliability of borrowers must be made with greater care than in the case of bank loans.
3. The lending capacity of a small loan agency is limited to its cash capital on which it must pay dividends; that of a commercial bank includes, in addition to this resource, the deposits of its customers on which it does not have to pay dividends or interest. Consequently, an interest charge of 6 per cent on loans of a commercial bank will produce a profit much larger than 6 per cent on its capital.

These companies compete with the personal loan departments of the commercial banks and with the Morris Plan institutions, but there appears to be room for all three types of organizations. Certainly the personal loan business, in this country, is just in its infancy, and the next decade should see a rapid development of this profitable form of the banking business.

Morris Plan Banks.—Morris Plan banks have grown rapidly in this country since 1910 when Arthur J. Morris, a lawyer of Norfolk, Va., made an exhaustive investigation of the cooperative banks of Europe and decided that he would inaugurate in America a system of granting personal credit to wage and salary earners modeled after the European systems, but with certain modifications made necessary by national conditions in this country.

The first Morris Plan bank, established in Norfolk, was successful from the outset, and the movement spread to other parts of this country. At the present time, 145 of the principal cities of the United States are served by Morris Plan institutions. The total resources of these companies amount to approximately $200,000,000.[1]

The Morris Plan Corporation of America serves as a coordinating institution for all Morris Plan banks. It owns the trade-mark and trade name *Morris Plan*, as well as the copyrighted forms under which that method of banking is conducted. It has the exclusive right to license new institutions which desire to use the name and the plan. It also renders a continuous service for the banks consisting of technical

[1] Bennett, F. B., Jr., "Twenty Years of the Morris Plan," *United States Investor*, February, 1930.

advice, comparative statistics of the results of the operation of the banks, and examinations and audits. The purpose of this organization is not only to provide effective help and assistance for the local institutions, but to act as a general agency for advancing the public interest in the Morris Plan and industrial financing. It also interests itself in legislation and similar matters, with the view of making more effective the work of the Morris Plan System. It will rediscount trade acceptances and notes for the local banks, and, in that way, it provides a reservoir of credit in case the local banks need assistance in carrying out their programs.

The banks organized on the Morris plan do not accept as security chattel mortgages or salary assignments, but loan amounts ranging from $50 to $5,000 on the personal credit of the borrower, together with the indorsement of two responsible citizens. In Pennsylvania the Morris Plan banks are considered as small loan brokers and so fall under the jurisdiction of the Small Loan Act, which among other things limits their loans to $300 per borrower.

The borrower and the indorsers are compelled to fill out questionnaires requesting information concerning the character, the financial record, and the responsibility of each party.

When the application for the loan satisfies the officials of the local bank, the borrower, together with the indorsers, signs a note and pledge as security an instalment certificate of a denomination equal to the amount of the note for which he agrees to pay in 50 weekly instalments, or equivalent semimonthly or monthly instalments. This certificate is assigned by the borrower to the bank as security for the loan. The borrower is also charged an investigation fee of $1 for each $50 borrowed. This fee, however, is not to exceed $5. The reason for this investigation fee is to enable the banks to undertake a thorough investigation of the character and capacity of the borrower, as it will be obvious that there is no tangible security behind the loan. After the twenty-fifth payment has been made, the payments draw interest at 4 per cent, and at the end of 50 weeks, the full-paid certificates can be used either to cancel the loan or can be exchanged for a full-paid Morris Plan investment certificate which bears interest at 5 per cent and which can be cashed at the bank on 30 days' notice.

The legal rate of interest of the state in which the bank is located is charged the borrower. An organization called the *Morris Plan Insurance Society* has been formed to write insurance upon the lives of Morris Plan borrowers, who have the optional right of utilizing the services of that organization.

An analysis of loans made by the Morris Plan Company of New York indicates the following classification of types of borrowers:[1]

20 per cent to factory workers and laborers
37 per cent to clerks, salesmen, and buyers
23 per cent to business men
4 per cent to business women
7 per cent to housewives
3 per cent to professional men
2 per cent to professional women
4 per cent to public-service employees
100 per cent (83 per cent to men, 17 per cent to women).

The Morris Plan banks extend credit only for useful purposes. The following table gives some indication as to the reasons for the extension of credit to borrowers from one of the banks:

Purposes for Which Loans Are Made[2]

The wage-earner borrowed:
$300 to bring family to United States
250 to purchase small hand printing press for job work at home evenings
250 to pay for operation on wife
200 to pay for the birth of a child
150 to pay for a son's operation
150 to pay debt to a "loan shark"
100 to buy furniture
50 to pay grocer and coal bill

The salaried man borrowed:
$500 to complete home
400 to make payment on home
350 to consolidate debts
300 to build garage
300 to instal heating plant
300 to pay for wife's confinement
250 to pay for operation
200 to pay taxes and insurance
150 to pay for a business course
100 to paint the house

The professional man borrowed:
$1,000 to pay mortgage
700 to move and furnish new office
500 to purchase dental instruments
500 to provide working fund while awaiting payment of clients' bills
300 to pay tuition
250 to pay for a car
300 to pay note owing to a friend.

[1] "The Morris Plan," p. 6, published by Morris Plan Corp. of America.
[2] *Ibid*, pp. 7 and 8.

The merchant borrowed:

$5,000 to instal an elevator and enhance values of upper floors
3,500 to buy out a partner
2,500 to instal modern showcases and shelves
2,000 to renovate his store
1,000 to purchase new merchandise
600 to make advance payment on a rooming-house lease
500 to liquidate small debts and maintain his credit.

The business woman borrowed:

$300 to pay for wedding
300 to pay taxes on her mother's home
250 to buy a share in a small dressmaking establishment
200 to purchase winter clothing
150 to send a brother to school
150 to pay for a vacation
100 to pay the dentist.

The advantages of the Morris Plan are usually states as follows:

1. Such institutions make possible the extension of credit to the salary- and wage-earning class where otherwise they would either be forced to go to the loan sharks and pay usurious rates, or be compelled to do without credit. There is a growing opinion that such a group is entitled to receive credit to the same extent as are commercial enterprises, provided the credit so secured is to be used for a legitimate purpose, and it can be shown that the borrowers are of the highest character.

2. In view of the fact that the loans are based primarily upon character, such institutions will develop self-respect, because they tend to inculcate into the wage-earning group the value of building up a good reputation.

3. Thrift is promoted. The partial-payment plan operating under this system trains the borrower to save regularly, and it is alleged that after the loan has been paid, the borrower has become so accustomed to putting aside a sum each week that he will continue to do so, while at the same time the loans are made easy to repay because of these periodic and regular payments.

The rapid increase in the number of Morris Plan banks from 1910 to 1928 might be regarded as an indication of the growing importance of the business of supplying industrial credit to a group composing a substantial percentage of the population of the United States, and if one takes this growth, together with the growth in the number of

industrial loan corporations which have been formed, and which have been referred to previously in this chapter, it seems to be conclusive proof that such institutions are meeting a need for a type of finance which prior to 1910 was more or less left to those whose reputations in the banking field were not of the highest. Practically 85 per cent of the population of the United States receive incomes of less than $3,000 per year, and therefore are potential borrowers from industrial finance companies, Morris Plan banks, or the personal loan departments of commercial banks. It would seem, therefore, that industrial finance is a growing field, and probably will become recognized more and more as a legitimate part of the work of the banker.

Investment Trusts.—Investment trusts are financial corporations whose primary purpose is the investment and reinvestment of stockholders' capital in securities. They had their origin in Great Britain some 60 years ago, where they have in general been markedly successful. In the United States, the Alexander Fund was organized in 1907, but investment trusts, as such, did not begin to operate until 1921. From that date they have grown in number and size with startling rapidity and in April, 1930, it was estimated that between four and five hundred investment trusts with total capital of over $4,000,000,000 were operating in this country.

The general purpose of investment trusts is to give to the investor of limited means an opportunity to obtain diversity of investment and the benefit of skilled investment experience and management. The investment trust obtains its capital by the sale of its own stock to the public and invests it in well-selected and diversified securities. Profits accrue to it in the form of cash and stock dividends, interest, rights, and appreciation in the principal value of the securities bought. In some instances, the investment trusts will participate in underwriting, and secure an underwriting profit or obtain the securities at a lower price than the public, or both. There is, of course, the corresponding risk of depreciation in the value of securities purchased, but this risk is common to all investment, and from the standpoint of the small investor the risk is somewhat obviated in respect to a well-managed investment trust, by the diversity of securities made possible by the larger capital to be invested, and by the knowledge and skill of the investment trust managers.

Types of Investment Trusts. *a. General Management Trusts.*—In trusts of this type, the selection of securities for investment is left entirely to the discretion of the managers, who, subject occasionally to percentage limitations, may invest in securities of any type or character.

Typical of the powers granted to trusts of this character are the charter powers of the Allied International Investing Corporation.[1]

The nature of the business of this corporation and the objects and purposes to be transacted, promoted and carried out by it are as follows:

To acquire by purchase, subscription, contract, or otherwise and to hold, sell, exchange, mortgage, pledge, or otherwise dispose of, all forms of securities . . . and to aid by loan, subsidy, guaranty or otherwise, any person or persons issuing, creating, or responsible for any such bonds or other evidences of indebtedness, or stock or certificates of interest therein, or other securities owned or held by this corporation, or by any corporation in which this corporation may have an interest as stockholder or otherwise. . . . To purchase, acquire, hold, sell, exchange, mortgage . . . of every kind, character, and description . . . to purchase, sell and deal generally in foreign and domestic exchange. To make, enter into and carry out any arrangements which may be deemed to be for the benefit of this corporation, with any domestic or foreign governmental, municipa' or public authority. . . . To acquire, in whole or in part the business, good will, rights, property and assets of all kinds. . . . To apply for, obtain, register, purchase, lease or otherwise acquire. . . . To act in any and all parts of the world in any capacity whatsoever. . . . To cause to be formed, merged or reorganized or liquidated. . . . To borrow money; to issue bonds. . . . To indorse or guarantee the payment of principal of interest, or dividends. . . . To merge, amalgamate or consolidate, in accordance with law, with any other corporation having objects altogether or in part similar to the objects of this corporation. . . . To sell, assign, transfer, convey, mortgage, pledge, and otherwise dispose of, all the property and the entire business of this corporation. . . . To purchase, hold, sell, transfer, re-issue or cancel, shares of its own capital stock. . . . In any and all parts of the world, to manufacture, produce, purchase, or otherwise acquire, sell or otherwise dispose of, import, export. To enter into, make, perform and carry out or cancel, rescind contracts. . . . To conduct its business in the state of Delaware, and in other states. . . . To undertake, contract, or carry on any business incidental to or in aid of, or convenient or advantageous to, any of the objects or purposes of this corporation. In general, to do any or all of the things hereinbefore set forth, and such other things as are incidental or conducive to the attainment of the objects and purposes of this corporation. . . .

Also,

. . . it being expressly intended that this corporation may engage in enterprises or make investment or reinvestments of a nature which may be deemed speculative or hazardous, and that some one or more of its officers or directors may be personally interested either directly or indirectly, in such enterprises and transactions, and that this corporation may buy from, sell, or deal with, its

[1] Ottinger, Albert, "Investment Trusts," p. 31ff.

directors or officers in their individual capacity, or with corporation firms or associations in which this corporation's officers and directors are interested either directly or indirectly.

Also,

. . . no director or officer shall be liable to this corporation or to any stockholder or creditor of this corporation, for any error or mistake in judgment, or for any matter or thing whatsoever, except affirmative bad faith, nor for any profit realized by him or them, directly or indirectly, from transactions between this corporation and its officers or directors, or between this corporation and the corporations, firms and associations in which this corporation's officers or directors are interested.

b. Special Management Trusts.—These trusts exercise management in the purchase and sale of securities, but do not invest in as extended a field as the general management trusts. For example, some of the special management trusts buy mainly bonds and mortgages; others specialize in the common stocks of certain public utilities, or railways; still others specialize in the shares of financial institutions, chiefly banks.

c. Fixed or Limited Management Investment Trusts.—These trusts acquire a certain selected list of securities, which are deposited with a corporate trustee and issues against them certificates representing a fractional interest in the holdings. Income, in whatever form received, is distributed pro rata to the certificate holders. Except in special cases, the stocks originally purchased may not be changed after the certificates are issued. There is thus little or no management involved. The value of the certificates fluctuates with changes in the market value of the underlying securities. The certificate holders benefit by a certain diversity of investment and a careful initial selection of the securities trusteed for their interest. These limited or fixed trusts may also specialize in certain fields as, for example, bank shares or public utilities.

d. Finance and Holding Companies.—Certain finance and holding companies are improperly called investment trusts. They own enough of the securities of subsidiary corporations to control and direct their policies, and obtain a considerable part of their profit from issuing and underwriting activities. The ordinary investment trust limits the quantity of its investment in individual companies to gain the safety and benefit of wide diversification, whereas the success and profits of the financing and holding company is largely dependent upon the success of the comparatively few companies which it controls.

Investment Trust Organizers.—Ottinger [1] lists four types of investment trust sponsors.

1. Groups of professional investment-trust managers
2. Firms of investment consultants who operate investment trusts in addition to their investment advisory work
3. Issuing and investment banking houses
4. Banks and trust companies and their associated security companies.

Investment Trust Financing.—The capital set-up of investment trusts varies widely in this country. The simplest form is that of the fixed investment trust which raises capital by the issuance of certificates representing a fractional interest in the securities deposited with the trustee. There is here only one type of issued security, although the certificates are frequently issued in series.

A few of the management investment trusts issue only one class of shares, but most of the investment trusts in this country raise their capital by the sale of bonds or debentures, and preferred and common stocks.

The debentures issued by British investment trusts are usually simple investment issues carrying a fixed rate of return, with no participating features. Those issued by American investment trusts frequently carry with them a bonus of common stock, or warrants to subscribe to common stock at a fixed price per share, or contain privileges of conversion into common stock at a fixed ratio. Bearing these participating features, it commonly happens that the ratio of book value behind them is less than in the case of debentures without the participating privileges.

The same difference between the policies of British and American investment trusts is observable in the case of preferred stock. The British trusts issue preferred stock which does not participate in earnings beyond the agreed rate, while it is a common practice for American trusts to sell preferred stock with a bonus in common, or warrants to subscribe to common stock, or conversion privileges.

The common stock of the British trusts invariably has a par value, while it is a frequent practice here to issue no par stock and use substantial portions thereof as a bonus to organizers, to purchasers of bonds or preferred stock, and for the exercise of warrants.

In addition to the capital acquired by the sale of stock and bonds, some of the investment trusts borrow extensively from banks.

[1] *Supra cit.*

Advantages of Investment Trusts.—If properly organized and managed, the investment trusts afford sounder opportunities for investment from the standpoint of the small investor than would be ordinarily possible in the selection of individual securities. The investment trusts should afford a higher average yield through diversity of securities, managerial skill in the purchase and sale of investments, lowered costs of purchase, if the trust participates in underwriting, and the investment of borrowed funds at a higher rate of return. Security should be enhanced by the proper diversification of securities held. In a declining market the investment trusts should suffer less than holders of individual securities. Except in a panic, all securities do not decline at once, and if the investment trust holds some foreign as well as domestic securities, there is the further probability that the decline will not be general throughout the leading markets of the world.

Dangers Inherent in Investment Trusts.—*a.* In the capital set-up of some investment trusts, by a separation of common stocks into classes, the ultimate control of the trust may be vested in a group which advanced but a very small proportion of the capital. The nature of the control is sometimes skilfully concealed by the complexity of the capital set-up. From the public standpoint, simplicity of form should be encouraged.

b. In the organization and management of investment trusts by investment banking houses, there is the danger that the investment trust may be used as a dumping ground for securities underwritten by the banking house, and which it could not dispose of to the public. This raises the whole question of management. The success of the trust is dependent upon the skill and judgment of the managers, and danger is ahead if the managers are utilizing the trust primarily for the advancement of their own private interests.

c. It is difficult to rigidly determine the borderline between speculation and investment, but in general in investment the emphasis is laid on security of principal and a continuous return in the form of interest or dividends, while in speculation the interest and dividend return is subordinate to the consideration of the enhancement of capital value realized by sale. If an investment trust deals extensively in common stocks paying no dividends, and is active in the purchase and sale of securities of that type, it would seem that the term investment trust is a misnomer and the corporation is simply a trading pool of a speculative character. This is particularly true if in its trading activities it buys or sells on margin or by means of extensive borrowings from banks. Short selling by investment trusts is to be condemned

as a purely speculative undertaking, and in fact the charters or by-laws of many of the trusts specifically forbid it. This does not imply any criticism of short selling or stock-market speculation as such, but it should not be carried on under the name of an investment trust.

d. One of the proper sources of profit of an investment trust is the enhancement of the capital value of the securities purchased, but unless this profit is realized by sale, it should not be used as a basis for the declaration and payment of cash dividends, nor should it be reported as a part of annual earnings unless realized. Substantial reserves should be built up to cover possible depreciation in security values.

e. Considerable diversity of opinion exists on the advisability of making public the investment holdings of investment trusts. A majority of the management trusts do not publish their holdings. Some publish a classification of their investments, showing the distribution of the securities among industries or by country or the proportion of bonds, and common and preferred stocks held. Still others mention only some of the securities held. While, in general, publicity tends to add to the safety of investment, still, as in active management trusts the lists when they reach the public will be to some extent out of date and will not indicate the cost of acquisition, they may deceive investors as much as inform them of the standing of their company.

Whatever criticisms may be directed against investment trusts, it is evident that they have been very popular, and it seems probable that they will in the future play a still more important part in our banking and financial system.

Edge Export Finance Companies.—Prior to the establishment of the Federal Reserve System most of our foreign trade was financed by London banks. The Federal Reserve Act was designed among other things to enable American banks to participate in our foreign-trade financing. This was accomplished by permitting national banks to accept drafts drawn for import or export purposes, thus competing with foreign banks as acceptors of bills, and by permitting national banks with capital and surplus in excess of $1,000,000 to open branches in foreign countries. By an amendment in 1916, national banks with a capital and surplus in excess of $1,000,000 were authorized to invest in the capital stock of banks or corporations engaged in foreign financing. These corporations, however, could only be organized under state laws, and for the purpose of enabling institutions to organize with a Federal charter to engage in international banking or financing foreign trade, the Edge Act was passed as an amendment to the Federal Reserve Act, Dec. 24, 1919.

The more important provisions of the act follow:

Powers.—Each corporation so organized shall have power under such rules and regulations as the Federal Reserve Board may prescribe:

a. To purchase, sell, discount, and negotiate, with or without its indorsement or guaranty, notes, drafts, checks, bills of exchange, acceptances, including bankers' acceptances, cable transfers, and other evidences of indebtedness; to purchase and sell, with or without its indorsement or guaranty, securities, including the obligations of the United States or of any state thereof but not including shares of stock in any corporation except as herein provided; to accept bills or drafts drawn upon it subject to such limitations and restrictions as the Federal Reserve Board may impose; to issue letters of credit; to purchase and sell coin, bullion, and exchange; to borrow and to lend money; to issue debentures, bonds, and promissory notes under such general conditions as to security and such limitations as the Federal Reserve Board may prescribe, but in no event having liabilities outstanding thereon at any one time exceeding ten times its capital stock and surplus; to receive deposits outside of the United States and to receive only such deposits within the United States as may be incidental to or for the purpose of carrying out transactions in foreign countries or dependencies or insular possessions of the United States; and generally to exercise such powers as are incidental to the powers conferred by this act or as may be usual, in the determination of the Federal Reserve Board, in connection with the transaction of the business of banking or other financial operations in the countries, colonies, dependencies, or possessions in which it shall transact business and not inconsistent with the powers specifically granted therein. Nothing contained in this section shall be construed to prohibit the Federal Reserve Board, under its power to prescribe rules and regulations, from limiting the aggregate amount of liabilities of any or all classes incurred by the corporation and outstanding at any one time. Whenever a corporation organized under this section receives deposits in the United States authorized by this section it shall carry reserves in such amounts as the Federal Reserve Board may prescribe, but in no event less than 10 per cent of its deposits.

Branches. b.—To establish and maintain for the transaction or its business branches or agencies in foreign countries, their dependencies or colonies, and in the dependencies or insular possessions of the United States, at such places as may be approved by the Federal Reserve Board and under such rules and regulations as it may prescribe, including countries or dependencies not specified in the original organization certificate.

Stock Holdings. c.—With the consent of the Federal Reserve Board to purchase and hold stock or other certificates of ownership in any other corporation organized under the provisions of this section or under the laws of any foreign country, or a colony or dependency thereof, or under the laws of any state, dependency, or insular possession of the United States but not engaged in the general business of buying or selling goods, wares, merchandise, or commodities in the United States, and not transacting any business in the United

States except such as in the judgment of the Federal Reserve Board may be incidental to its international or foreign business: *Provided, however,* That, except with the approval of the Federal Reserve Board, no corporation organized hereunder shall invest in any one corporation an amount in excess of 10 per cent of its own capital and surplus, except in a corporation engaged in the business of banking, when 15 per cent of its capital and surplus may be so invested: *Provided further,* That no corporation organized hereunder shall purchase, own, or hold stock or certificates of ownership in any other corporation organized hereunder or under the laws of any state which is in substantial competition therewith, or which holds stock or certificates of ownership in corporations which are in substantial competition with the purchasing corporation.

Nothing contained herein shall prevent corporations organized hereunder from purchasing and holding stock in any corporation where such purchase shall be necessary to prevent a loss upon a debt previously contracted in good faith; and stock so purchased or acquired in corporations organized under this section shall within 6 months from such purchase be sold or disposed of at public or private sale unless the time to so dispose of same is extended by the Federal Reserve Board.

No corporation organized under this section shall carry on any part of its business in the United States except such as, in the judgment of the Federal Reserve Board, shall be incidental to its international or foreign business: *And provided further,* That, except such as is incidental and preliminary to its organization, no such corporation shall exercise any of the powers conferred by this section until it has been duly authorized by the Federal Reserve Board to commence business as a corporation organized under the provisions of this section.

Price Control.—No corporation organized under this section shall engage in commerce or trade in commodities except as specifically provided in this section, nor shall it either directly or indirectly control or fix or attempt to control or fix the price of any such commodities. The charter of any corporation violating this provision shall be subject to forfeiture in the manner hereinafter provided in this section. It shall be unlawful for any director, officer, agent, or employee of any such corporation to use or to conspire to use the credit, the funds, or the power of the corporation to fix or control the price of any such commodities, and any such person violating this provision shall be liable to a fine of not less than $1,000 and not exceeding $5,000 or imprisonment not less than 1 year and not exceeding 5 years, or both, in the discretion of the court.

Capital.—No corporation shall be organized under the provisions of this section with a capital stock of less than $2,000,000, one-quarter of which must be paid in before the corporation may be authorized to begin business, and the remainder of the capital stock of such corporation shall be paid in instalments of at least 10 per cent on the whole amount to which the corporation shall be limited as frequently as one instalment at the end of each succeeding 2 months from the time of the commencement of its business operations until the whole

of the capital stock shall be paid in. . . . Any national banking association may invest in the stock of any corporation organized under the provisions of this section, but the aggregate amount of stock held in all corporations engaged in business of the kind described in this section and in Sec. 25 of the Federal Reserve Act as amended shall not exceed 10 per cent of the subscribing bank's capital and surplus.

American Ownership.—A majority of the shares of the capital stock of any such corporation shall at all times be held and owned by citizens of the United States, by corporations the controlling interest in which is owned by citizens of the United States, chartered under the laws of the United States or of a state of the United States, or by firms or companies, the controlling interest in which is owned by citizens of the United States. The provisions of section 8 of the act approved Oct. 15, 1914, entitled "An act to supplement existing laws against unlawful restraints and monopolies, and for other purposes," as amended by the acts of May 15, 1916, and Sept. 7, 1916, shall be construed to apply to the directors, other officers, agents, or employees of corporations organized under the provisions of this section: *Provided, however,* That nothing herein contained shall (1) prohibit any director or other officer, agent, or employee of any member bank, who has procured the approval of the Federal Reserve Board from serving at the same time as a director or other officer, agent, or employee of any corporation organized under the provisions of this section in whose capital stock such member bank shall have invested; or (2) prohibit any director or other officer, agent, or employee of any corporation organized under the provisions of this section, who has procured the approval of the Federal Reserve Board, from serving at the same time as a director or other officer, agent, or employee of any other corporation in whose capital stock such first-mentioned corporation shall have invested under the provisions of this section.

No member of the Federal Reserve Board shall be an officer or director of any corporation organized under the provisions of this section, or of any corporation engaged in similar business organized under the laws of any state, nor hold stock in any such corporation, and before entering upon his duties as a member of the Federal Reserve Board he shall certify under oath to the Secretary of the Treasury that he has complied with this requirement.

Shareholders in any corporation organized under the provisions of this section shall be liable for the amount of their unpaid stock subscriptions. No such corporation shall become a member of any Federal Reserve bank. . . .

The directors of any corporation organized under the provisions of this section may, semi-annually, declare a dividend of so much of the net profits of the corporation as they shall judge expedient; but each corporation shall, before the declaration of a dividend, carry one-tenth of its net profits of the preceding half year to its surplus fund until the same shall amount to 20 per cent of its capital stock.

The Federal Reserve Board has issued, from time to time, regulations amplifying and interpreting the provisions of the act. The last

regulations are the Series of 1928, of which probably the most important is the following:

XIII. Acceptances.—Kinds.—Any corporation may accept (1) drafts and bills of exchange drawn upon it which grow out of transactions involving the importation or exportation of goods, and (2) drafts and bills of exchange which are drawn by banks or bankers located in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange as required by the usages of trade in such countries, dependencies, and possessions, provided, however, that *no Corporation shall exercise its power to accept drafts or bills of exchange if at the time such drafts or bills are presented for acceptance it has outstanding any debentures, bonds, notes, or other such obligations issued by it.*

Maturity.—Except with the approval of the Federal Reserve Board, no corporation shall accept any draft or bill of exchange which grows out of a transaction involving the importation or exportation of goods with a maturity in excess of 6 months, or shall accept any draft or bill of exchange drawn for the purpose of furnishing dollar exchange with a maturity in excess of 3 months.

Limitations.—(1) Individual drawers: No acceptances shall be made for the account of any one drawer in an amount aggregating at any time in excess of 10 per cent of the subscribed capital and surplus of the corporation, unless the transaction be fully secured or represents an exportation or importation of commodities and is guaranteed by a bank or banker of undoubted solvency. (2) Aggregates: Whenever the aggregate of acceptances outstanding at any time (*a*) exceed the amount of the subscribed capital and surplus, 50 per cent of all the acceptances in excess of the amount shall be fully secured; or (*b*) exceeds twice the amount of the subscribed capital and surplus, all the acceptances outstanding in excess of such amount shall be fully secured. (The corporation shall elect whichever requirement (*a*) or (*b*) calls for the smaller amount of secured acceptances.) In no event shall any corporation have outstanding at any one time acceptances drawn for the purpose of furnishing dollar exchange in an amount aggregating more than 50 per cent of its subscribed capital and surplus.

Reserves.—Against all acceptances outstanding which mature in 30 days or less, a reserve of at least 15 per cent shall be maintained, and against all acceptances outstanding which mature in more than 30 days a reserve of at least 3 per cent shall be maintained. Reserves against acceptances must be in liquid asset of any or all of the following kinds: (1) cash, (2) balances with other banks, (3) acceptances of other banks or bankers, and (4) obligations of the government of the United States.

Types of Edge Act Corporations.—Because of the foregoing regulation, each Edge Act corporation must choose one of two methods of foreign trade financing, first, operation as an investment trust, issuing its own debentures against foreign securities held as collateral, or

second, the ordinary financing of shipments of goods abroad through the exercise of its banking powers, particularly its right to accept.

As an investment trust, the law authorizes these institutions: (1) to purchase and sell, with or without their indorsement or guaranty, securities, including obligations of the United States or any state thereof, but not including shares of stock, except that with the consent of the Federal Reserve Board stock of other Edge Act corporations or other corporations may be purchased and held under certain conditions, explained in the act and regulations quoted above, and (2) to issue debentures, bonds, and promissory notes under such general conditions as to security and under such limitations as the Federal Reserve Board may prescribe, but in no event having liabilities outstanding thereon at any one time exceeding ten times the capital stock and surplus of the issuing corporation.

Several charters were applied for shortly after the act was passed. On Apr. 17, 1920, the Federal Reserve Board approved the charter of the *First Federal Foreign Banking Corporation*, and in December, 1920, the *Federal International Banking Company* secured the approval of the board. Both of these corporations were of the acceptance type. Articles of association of *Foreign Trade Financing Corporation* were approved Jan. 28, 1920, this corporation to operate on the investment-trust plan.

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CHAPTER XXXVI

AGRICULTURAL CREDITS

While it no longer can be said that the United States is essentially an agricultural producing nation, yet, nevertheless, the importance of the agricultural industry to this country is still very great, and many of the banks located in agricultural districts are almost wholly engaged in advancing credit to agricultural enterprises.

Farm credit can be divided into three general types: (1) long-term credit, covering periods ranging anywhere from 3 to 40 years; (2) intermediate credit, covering periods ranging from 6 months to 3 years; and (3) short-term credit, covering periods less than 6 months. Of the three types of farm credit, long-term credit is used more extensively than are the others, and therefore will be discussed first.

The Federal Farm Loan Act, which became a law on July 17, 1916, was designed mainly to create long-term credit facilities for those engaged in agricultural production. The title states that its purpose is:

> To provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create government depositaries and financial agents for the United States, and for other purposes.

In a circular issued by the Federal Farm Loan Board this was still further amplified. This circular stated that the purpose is,

> . . . to lower and equalize interest rates on first mortgage farm loans; to provide long-term loans with the privilege of repayment in instalments through a long or short period of year, at the borrower's option; to assemble the farm credits of the nation to be used as security for money to be employed in farm development; to stimulate cooperative action among farmers; to make it easier for the landless to get land; and to provide safe and sound long-term investments for the thrifty (Federal Farm Loan Board, Circular No. 5, revised).

In carrying out the announced purposes, the act provides for (1) a Federal Farm Loan board consisting of seven members, including the Secretary of the Treasury, who is chairman, ex-officio, the remaining six members appointed by the President of the United States, by and

with the advice and consent of the Senate. Of these six members appointed by the President, not more than three are appointed from one political party, and all six members are citizens of the United States, who devote their entire time to the business of the Federal Farm Loan Board; (2) 12 Federal Land banks located in cities designated by the first Federal Farm Loan Board, and which must be other than those in which the Federal Reserve banks were located. (3) National Farm Loan associations, organized and controlled by at least ten or more of the borrowing farmers, and (4) Joint Stock Land banks, which are privately owned and operated long-term or agricultural-credit institutions. The Federal Farm Loan Board supervises the activities of the Federal Farm Loan System, and periodically examines the affairs of the twelve Federal Land banks.

The 12 cities selected serve as the headquarters for their respective districts and are as follows:

District number	States	Federal Land bank cities
1	Maine, Massachusetts, Vermont, New Hampshire, Rhode Island, Connecticut, New Jersey, and New York	Springfield, Mass.
2	Pennsylvania, West Virginia, Maryland, Delaware, Virginia and District of Columbia	Baltimore, Md.
3	North Carolina, South Carolina, Georgia, and Florida	Columbia, S. C.
4	Indiana, Ohio, Kentucky, and Tennessee	Louisville, Ky.
5	Louisiana, Mississippi, and Alabama	New Orleans, La.
6	Illinois, Missouri, and Arkansas	St. Louis, Mo.
7	North Dakota, Minnesota, Wisconsin, and Michigan	St. Paul, Minn.
8	Wyoming, Nebraska, South Dakota, and Iowa	Omaha, Neb.
9	New Mexico, Kansas, Colorado, and Oklahoma	Wichita, Kan.
10	Texas	Houston, Texas
11	California, Nevada, Utah, and Arizona	Berkeley, Cal.
12	Idaho, Washington, Montana, and Oregon	Spokane, Wash.

Directors.—Each Federal Land bank is governed by a board of directors consisting of nine members, each one holding office for 3 years. Six of the said directors are known as "local directors," and are chosen by, and are representative of, the National Farm Loan associations. The remaining three directors are known as "district directors,"'and are appointed by the Federal Farm Loan Board and represent the public

interest. The directors of the Federal Farm Land banks must have been for at least 2 years residents of the district for which they are elected, and at least one district director must be experienced in practical farming, and actually engaged at the time of his appointment in farming operations within the district.

Capital.—Each of the 12 Federal Land banks started business with a subscribed capital of $750,000. This, under the terms of the act, automatically increases by 5 per cent of each loan made. After the Federal Land bank has extended credit to the limit of its original capital, it can secure additional funds to lend the farmers by issuing Federal Land bank bonds upon the security of the mortgages taken as collateral when credit was advanced to the farmers. Thus it appears that no limit exists in so far as the lending capacity of the banks is concerned, so long as the Land banks can find a market for their securities.

Powers.—The powers of the Federal Land banks as stated in Sec. 13 of the Act are as follows:

First. To issue, subject to the approval of the Federal Farm Loan Board, and to sell farm loan bonds of the kinds authorized in this act, to buy the same for its own account, and to retire the same at or before maturity.

Second. To invest such funds as may be in its possession in the purchase of qualified first mortgages on farm lands situated within the Federal Land bank district within which it is organized or for which it is acting.

Third. To receive and to deposit in trust with the farm loan registrar for the district, to be by him held as collateral security for farm loand bonds, first mortgages upon farm land qualified under Sec. 12 of this act, and to empower national farm loan associations, or duly authorized agents, to collect and immediately pay over to said Land banks the dues, interest, amortization instalments and other sums payable under the terms, conditions, and covenants of the mortgages and of the bonds secured thereby.

Fourth. To acquire and dispose of

a. Such property, real or personal, as may be necessary or convenient for the transaction of its business, which, however, may be in part leased to others for revenue purposes.

b. Parcels of land acquired in satisfaction of debts or purchased at sales under judgments, decrees, or mortgages held by it. But no such bank shall hold title and possession of any real estate purchased or acquired to secure any debt due to it, for a longer period than 5 years, except with the special approval of the Federal Farm Loan Board in writing.

Fifth. To deposit its securities, and its current funds subject to check, with any member bank of the Federal Reserve System, and to receive interest on the same as may be agreed.

Sixth. To accept deposits of securities or of current funds from national farm loan associations holding its shares, but to pay no interest on such deposits.

Seventh. To borrow money, to give security therefor, and to pay interest thereon.

Eighth. To buy and sell United States bonds.

Ninth. To charge applicants for loans and borrowers, under rules and regulations promulgated by the Federal Farm Loan Board, reasonable fees not exceeding the actual cost of appraisal and determination of title. Legal fees and recording charges imposed by law in the state where the land to be mortgaged is located may also be included in the preliminary costs of negotiating mortgage loans. The borrower may pay such fees and charges or he may arrange with the Federal Land bank making the loan to advance the loan and pay off in amortization payments. Such addition to the loan shall not be permitted to increase said loan above the limitations provided in Sec. 12.

National Farm Loan Associations.—National Farm Loan associations are corporations chartered by ten or more borrowing farmers whose aggregate applications for loans amount to not less than $20,000. In other words, the associations are the medium through which the farmer is supposed to act in applying for credit from the Federal Land banks.

It was evident that one of the fundamental reasons for the distressed conditions among American farmers was the unwillingness on the part of the farmers to cooperate, one with the other, not only in the distribution, but the actual production of their crops. It was thought that the creation of National Farm Loan associations would inculcate a spirit of cooperation among the farmers which might become contagious in other directions.

Each National Farm Loan association has an executive officer called the secretary-treasurer who acts as custodian of its funds, documents and records necessary to the conduct of the association, and who collects and transmits to Federal Land banks payments due them, such as interest, etc. The secretary-treasurer may or may not receive compensation for his services.

Ownership of each $5 share of stock in an association entitles a member to one vote; but in no case can a stockholder's votes exceed twenty. The amount of loans extended to any one borrower must in no case exceed a maximum of $25,000 nor may any one loan be for a sum less than $100; and the act states that preference shall be given to applications for loans of $10,000 and over.[1]

In the event of liquidation of any National Farm Loan association the stock in the Federal land bank held by such association is canceled

[1] Paragraph 7 of Sec. 12 of the Federal Farm Loan Act as amended by Sec. 307 of the Agricultural Credit Act.

and the Federal Land bank in question issues to the borrower through such association an equal amount of stock in the Federal Land bank, although the stock is held by the Federal Land bank as collateral on the loans of particular borrowers.

Purpose of Loans.—Loans made through an association may be secured for only the following purposes: (1) the purchase of land for agricultural uses; (2) the purchase of equipment, fertilizers, and livestock necessary for the proper and reasonable operation of the mortgaged farm; (3) buildings and improvements of farm land; (4) to liquidate indebtedness of the owner of the land mortgaged, existing at the time of the organization of the first National Farm Loan association established in or for the county in which his land is situated, or indebtedness subsequently incurred for purposes mentioned in this section.

How a Loan is Made.—The following example will give the student some idea as to the methods and conditions under which a loan is secured through the intermediary of the loan associations: Assuming that a Farm Loan association is in existence in a certain agricultural district in this country, Farmer A desires to borrow $8,000 in order to pay off an existing first mortgate on his property, and thereby reduce his interest payments. He applies to the secretary-treasurer of the National Farm Loan association and fills in an elaborate questionnaire called a loan application. A loan committee of the local National Farm Loan association, consisting of three members, will appraise the land offered as security for the loan, and as the land of this particular farmer is conservatively valued at $20,000 plus an appraisement of the permanent improvements at $5,000 Farmer A would be in a position to receive the loan, because under the provisions of the act a loan may be made up to 50 per cent of the appraised value of the land itself, plus an additional 20 per cent upon permanent and insured improvements thereon.

The loan committee makes a detailed written report signed by all three members giving the appraisal of Farmer A's land and improvements, and this report, together with the application for the loan, is submitted to the Federal Land bank of the particular district. These documents are then referred by the Land bank to a Federal Land bank appraiser, who makes an additional investigation.

Farmer A cannot be charged more than 6 per cent per annum, exclusive of the amortization payments. These payments themselves are so arranged that the entire debt shall be extinguished within an agreed period of not less than 5 years nor more than 40 years. The exact interest rate which Farmer A will pay is dependent upon the

prevailing rate of interest which the Federal Farm Land banks must pay on the bonds sold to the investing public, as the law states that the interest rates must be equal to the prevailing interest rates on the bonds sold, plus a 1 per cent charge for necessary overhead, etc. In other words, assuming that the prevailing rate of interest for Federal Farm Loan bonds is $4\frac{1}{2}$ per cent, Farmer A will pay $5\frac{1}{2}$ per cent interest on his loans. However, in no case can the interest rate to Farmer A exceed 6 per cent. Interest and principal payments are made in semi-annual instalments through the entire life of the loan.

The Federal Farm Loan Board can usually put out their bonds on a very favorable basis, because of the exempt feature attached to them. Yields on Federal Land bank bonds are higher than at any time during the 8 years previous, being 5.03 per cent for Aug. 12, 1929, as compared with 4.41 per cent for August, 1928. Higher rates on bonds have resulted in higher quotations on loans to farmers by both branches of the Federal Farm Loan System. On July 31, 1929, only 4 of the 12 Federal Land banks still quoted loans on mortgages at 5 per cent; 2 banks had a rate of $5\frac{1}{4}$ per cent, and 6 banks had a rate of $5\frac{1}{2}$ per cent, as compared with a year ago when 10 banks were loaning at 5 per cent and 2 banks at $5\frac{1}{4}$ per cent.

The bonds issued by the Federal Land banks are first-class investments because not only are they secured by first mortgages on farms, the appraised valuations of which are at least 50 per cent in excess of the amount loaned upon them, but repayment of each loan made is also guaranteed by the National Farm Loan association through which the loans were made, and in addition thereto the assets of all 12 of the Federal Farm Land banks are an added security behind the bonds of all the banks.

Assuming that Farmer A's loan has been approved by the Federal Land bank, he is requested to purchase stock in the local National Farm Loan association equal to 5 per cent of the amount of his loan. This stock is held by the local association as collateral security until Farmer A pays off the loan. During this period Farmer A will receive a proportionate share of any dividends which the association declares, and after the loan has been repaid, the amount invested in stock is returned to him. The local association in turn uses the money invested in its stock to purchase stock in the Federal Land bank of its district, so that it results in increasing the issued stock of the Federal Land bank extending the credit to an amount equal to 5 per cent of the farmer's loan. This is very significant, because under the terms of the

act the Federal Land banks can in turn issue and sell bonds to the investing public to an amount equal to twenty times their capital-stock issue, so that in practice it makes it possible for the Federal Land banks to extend credit to the farmers to an amount limited only by the investing public's ability to absorb and digest Federal Land bank securities.

Shareholders of every national farm loan association are individually responsible, equally and ratably, and not one for another, for all contracts, debts and engagements of such association to the extent of the amount of stock owned by them at the par value thereof, in addition to the amount paid in and represented by their shares. This is similar to the double-liability feature of national bank stock, and results in the farmers in the association guaranteeing each other's mortgages to the extent of an amount equal to 5 per cent of their individual mortgages.

Loans Made through Agents.—The framers of the act realized the difficulties involved in attempting to get a group of American farmers to organize associations, and authorized Federal Land banks to extend credit through approved agents in those districts where it was felt unlikely that an association would be formed. The loans made through the agents are subject to the same regulations as those made through associations. It was stated that an agent could be an incorporated bank, trust company, mortgage company, or savings institution when chartered by a state. The Federal Land banks may pay to such agent the actual expense of appraising land offered as security for a loan, and other expenses connected with the executing of the mortgage, etc., and in addition may pay to the agent a commission not to exceed one-half of 1 per cent premium upon the unpaid principal of the loan. This commission is to be deducted from dividends payable to the borrower on his stock in the Federal Land bank; while the expenses of paid agents become part of the loan and are paid off by amortization. The duty of the agent is to collect and remit payments, without charge, on loans when required, and to indorse and become liable upon mortgages received from them. Such mortgages are not to exceed ten times the capital and surplus of the agent.

In practice it has been difficult to get state banks to act as paid agents for the Federal Land bank because of the unattractive remuneration.

The Joint Stock Land Banks.—Prior to the passage of the Federal Farm Loan Act, certain private individuals had organized corporations for the purpose of dealing exclusively in agricultural loans. The

framers of the act took this into consideration and included within the act provision for institutions to be called *Joint Stock Land banks.* These banks must have capital stock of at least $250,000 each, subscribed by not less than ten stock holders. Double liability is attached to the ownership of stock in these banks. These banks must have a board of directors consisting of at least five members. The joint Stock Land banks have the right to issue bonds when and as the capital is fully paid up, just as the Federal Land banks do; and in making loans interest may be charged at a rate 1 per cent above the interest which the last issue of bonds bears. However, banks cannot charge over 6 per cent interest in any case.

The bonds put out by the Joint Stock Land banks are secured by first mortgages and have attached to them the tax-exempt provision. Incidentally, a great deal of criticism has been directed to this fact on the grounds that Joint Stock Land banks are private corporations and should not be allowed to issue non-taxable securities, but it is not within the province of this chapter to go into this controversy.

The amounts of mortgage funds advanced by the Joint Stock Land banks have decreased in the last few years, and certain of these banks have been in financial difficulties due primarily to the decline in agricultural land values.

Federal Intermediate Credit Banks.—The Agricultural Credits Act of March, 1923, amended the Farm Loan Act, and contained provisions creating twelve institutions to be called *Federal Intermediate Credit banks.* These banks are located in the same cities as are the Federal Land banks, and operate under the jurisdiction of the Federal Farm Loan Board. The officers and directors of the several Federal Land banks are ex-officio officers and directors of the Federal Intermediate Credit banks. However, the latter institutions retain their separate corporate identity.

The act states:

Sec. 202 *a.*—That Federal Intermediate Credit banks, when chartered and established, shall have power, subject solely to such restrictions, limitations, and conditions as may be imposed by the Federal Farm Loan Board not inconsistent with the provisions of this act,

1. To discount for, or purchase from, any national bank, and/or any state bank, trust company, agricultural credit corporation, incorporated livestock loan company, savings institution, cooperative bank, cooperative credit or marketing association of agricultural producers, organized under the laws of any state, and/or any note, draft, bill of exchange, debenture, or other such obligation the proceeds of which have been advanced or used in the first instance

for any agricultural purpose or for the raising, breeding, fattening, or marketing of livestock;

2. To buy or sell, with or without recourse, debentures issued by any other Federal Intermediate Credit bank; and

3. To make loans or advances direct to any cooperative association organized under the laws of any state and composed of persons engaged in producing, or producing and marketing, staple agricultural products, or livestock, if the notes or other such obligations representing such loans are secured by warehouse receipts, and/or shipping documents covering such products, and/or mortgages on lifestock: *Provided*, That no such loan or advance shall exceed 75 per cent of the market value of the products covered by said warehouse receipts and/or shipping documents, or of the livestock covered by said mortgages.

b. No paper shall be purchased from or discounted for any national bank, state bank, trust company, or savings institution under this section, if the amount of such paper added to the aggregate liabilities of such national bank, state bank, trust company or savings institution, whether direct or contingent (other than bona fide deposit liabilities), exceeds the amount of such liability permitted under the laws of the jurisdiction creating the same; or exceeds twice the paid-in and unimpaired capital and surplus of such national bank, state bank, trust company, or savings institution. No paper shall under this section be purchased from or discounted for any other corporation engaged in making loans for agricultural purposes or for the raising, breeding, fattening, or marketing of livestock, if the amount of such paper added to the aggregate liabilities of such corporation exceeds the amount of such liabilities permitted under the laws of the jurisdiction creating the same; or exceds ten times the paid-in and unimpaired capital and surplus of such corporation. It shall be unlawful for any national bank which is indebted to any Federal Intermediate Credit bank upon paper discounted or purchased under this section, to incur any additional indebtedness, if by virtue of such additional indebtedness its aggregate liabilities, direct or contingent, will exceed the limitations herein contained.

c. Loans, advances, or discounts made under this section shall have a maturity at the time they are made or discounted by the Federal Intermediate Credit bank of not less than 6 months nor more than 3 years. Any Federal Intermediate Credit bank may in its discretion sell loans or discounts made under this section, with or without its indorsement.

d. Rates of interest or discount charged by the Federal Intermediate Credit banks upon such loans and discounts shall be subject to the approval of the Federal Farm Loan Board. On the majority vote of the members of the Federal Farm Loan Board any Federal Intermediate Credit bank shall be required to rediscount the discounted paper of any other Federal Intermediate Credit bank at rates of interest to be fixed by the Federal Farm Loan Board.[1]

[1] From Sec. 202, Agricultural Credits Act, *Circular* 14, Federal Farm Loan Bureau of the Treasury Department, Public No. 503, 67th Congress, S. 4280.

Obviously the purpose of these banks is to supply intermediate credit to the agricultural industry, and in order to secure sufficient funds for such purpose each Federal Intermediate Credit bank has a subscribed capital stock of $5,000,000 and the Secretary of the Treasury is directed to subscribe to such capital stock on behalf of the United States, such subscriptions to be subject to call in whole or in part by directors of the said banks with 30 days' notice, to the Secretary of the Treasury, and with the approval of the Federal Farm Loan Board.

If additional funds are desired, the Federal Intermediate Credit banks may issue and sell collateral trust debentures or other similar obligations with a maturity at the time of issue of not more than 5 years. These debentures must be secured by at least a like face amount of cash or notes or other such obligations discounted or purchased or representing loans made by the bank in question. The amount of such debentures can at no time exceed ten times the amount of the paid-up capital and surplus of the issuing bank, and the act fixes the limit of interest on them at 6 per cent per annum, clearly stating that the United States government shall assume no liability directly or indirectly on the debentures.

Each Federal Intermediate Credit bank must establish a rate of discount approved by the Federal Farm Loan Board, which cannot exceed by more than 1 per cent the rate borne by its last preceding issue of debentures, nor can any borrower from the Intermediate Credit banks be allowed to discount with the banks without the approval of the Federal Farm Loan Board any obligation upon which the original borrower has been charged a rate of interest exceeding by more than $1\frac{1}{2}$ per cent the discount rate of the Federal Intermediate Credit bank at the time when such loan was made.

These banks may, subject to the approval of Federal Farm Loan Board, buy in the open market at or below par, for their account, and retire at or before maturity any debentures issued by them.

The Federal Farm Loan Board is authorized to supervise the activities of the Intermediate Credit banks in a manner similar to its examination of the Federal Land banks and the board is also empowered to make such rules and regulations not inconsistent with law as are deemed necessary for the efficient execution of the provisions of the act.

National Agriculture Credit Corporations.—The Agricultural Credits Act also authorized the creation of *National Agricultural Credit corporations* for the purpose of providing credit facilities for the agricultural and livestock industries in the United States. These organizations are to consist of at least 5 persons, who must forward, to the Comptroller

of the Currency, articles of association, and an organization certificate. Such corporations may be incorporated for a period of 50 years, and must have a capital of not less than $250,000 of which at least 50 per cent must be paid in at the time of organization, and the remainder must be paid in instalments of at least 10 per cent each on the whole amount of capital, and the entire authorized capital stock must be paid in within 6 months from the date upon which such corporation is authorized to operate.

The Act, Sec. 203, states as follows:

Sec. 203 *a*.—That each National Agricultural Credit corporation shall have power, under such rules and regulation as the Comptroller of the Currency may prescribe:

1. To make advances upon, to discount, rediscount, or purchase, and to sell or negotiate, with or without its indorsement or guaranty, notes, drafts, or bills of exchange, and to accept drafts or bills of exchange, which

A. Are issued or drawn for an agricultural purpose, or the proceeds of which have been or are to be used for an agricultural purpose;

B. Have a maturity, at the time of discount, purchase, or acceptance, not exceeding 9 months; and

C. Are secured at the time of discount, purchase, or acceptance by warehouse receipts or other like documents conveying or securing title to nonperishable and readily marketable agricultural products, or by chattel mortgage or other like instruments conferring a first and paramount lien upon livestock which is being fattened for market.

2. To make advances upon or to discount, rediscount, or purchase, and to sell or negotiate with or without its indorsement or guaranty, notes secured by chattel mortgages conferring a first and paramount lien upon maturing or breeding livestock or dairy herds, and having a maturity at the time of discount, rediscount, or purchase not exceeding 3 years.

3. To subscribe for, acquire, own, buy, sell and otherwise deal in Treasury certificates of indebtedness, bonds or other obligations of the United States to such extent as its board of directors may determine.

4. To act, when requested by the Secretary of the Treasury, as fiscal agent of the United States, and to perform such services as the Secretary of the Treasury may require in connection with the issue, sale, redemption, or repurchase of bonds, notes, treasury certificates of indebtedness, or other obligations of the United States.

5. To purchase, hold, acquire, and dispose of shares of the capital stock of any corporation organized under the provisions of Sec. 207, of this title, in an amount not to exceed at any time 20 per cent of its paid-in and unimpaired capital and surplus.

6. To purchase, hold, and convey real estate for the following purposes, and for no others:

A. Such as shall be necessary for its accommodation in the transaction of its business.

B. Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.

C. Such as shall be conveyed to it in satisfaction of loans or advances made or debts previously contracted in the course of its dealings.

D. Such as it shall purchase at sales under judgments, decrees, or mortgages held by the corporation or shall purchase to secure debts due to it.

7. To act as custodian, trustee, or agent for holders of notes, drafts or bills of exchange sold or negotiated under paragraphs 1 and 2 of subdivision *a* of this section or under Sec. 207.

8. To issue, subject to such regulations as the Comptroller of the Currency may prescribe, collateral trust notes or debentures, with a maturity not exceeding 3 years, and to pledge as security for such notes or debentures any notes, drafts, bills of exchange, or other securities held by the corporation under the terms of this title. The regulations of the Comptroller of the Currency may prescribe the form of notes or debentures, and of notes, drafts, bills of exchange, warehouse receipts, chattel mortgages, or other instruments which may be pledged as security therefor, the provisions which may be made with regard to release, substitution, or exchange of such securities, and with regard to protection, supervision, inspection, and reinspection of the agricultural commodities or livestock pledged or mortgaged as security therefor.

b. The United States government shall assume no liability, direct or indirect, for any debentures or other obligations issued under this title, and all such debentures and other obligations shall contain conspicuous and appropriate language, to be prescribed in form and substance by the Comptroller of the Currency and approved by the Secretary of the Treasury, clearly indicating that no such liability is assumed.

c. Any obligation referred to in paragraph 1 or 2 of subdivision *a* of this section, which is secured by chattel mortgage upon livestock of an estimated market value at least equal to the face amount of such obligation, may be additionaliy secured by mortgage or deed of trust upon real estate or by other securities, under such regulations as may be made by the Comptroller of the Currency.[1]

The corporations cannot loan to any person or corporation an amount exceeding 20 per cent of their paid-in and unimpaired capital and surplus, unless such loans are adequately secured by warehouse receipts representing readily marketable and non-perishable commodities, in which cases loans to any one person or corporation must not exceed 50 per cent of their paid-in and unimpaired capital and surplus.

[1] Quoted from Sec. 203, Agricultural Credit Act, March, 1923, *Circular* 14, Treasury Department, Federal Farm Loan Bureau. Public No. 503, Sixty-seventh Congress, S. 4280.

The National Agricultural Credit corporations may charge interest at the rates allowed by the laws of the states in which such corporations are located. The total amount of debentures such as specified in Part 6, above, to be issued by any corporation may not exceed ten times the paid-up capital and surplus of the corporation.

The act also provided for the creation of rediscount corporations for the purpose of rediscounting upon the indorsement of any National Agricultural Credit corporation, or of any bank or trust company which is a member of the Federal Reserve System, notes, drafts, bills of exchange, and acceptances, when such paper has been drawn for an agricultural purpose and has a maturity of not exceeding 9 months, or when such paper is secured by warehouse receipts or like documents conveying title to non-perishable and readily marketable agricultural products, or by documents secured by cattle paper.

These corporations are also authorized to discount notes, drafts or bills of exchange issued or drawn by cooperative agricultural associations when secured by documents conveying title to non-perishable and readily marketable agricultural products, and having a maturity at the time of discount not exceeding 9 months.

National Agricultural Credit corporations, before commencing business, must deposit with the Federal Reserve bank of their district United States government bonds equal in amount to at least 25 per cent of the paid in capital stock of the corporation, and must keep on deposit with the Federal Reserve bank United States government bonds [1] equal to $7\frac{1}{2}$ per cent of the aggregate indebtedness of such corporation.

The act states that all National Agricultural Credit corporations shall be under the supervision of the Comptroller of the Currency, who shall exercise the same general power of supervision as he now exercises over national banks.

Privilege is given to member banks of the Federal Reserve System to file application with the Comptroller of the Currency for permission to invest an amount not exceeding in the aggregate 10 per cent of the paid-in capital stock and surplus, in the stock of one or more of the National Agricultural Credit corporations, and upon approval of such application may purchase such stock. Any money owned by the National Agricultural Credit corporation may be kept on deposit in any of the member banks of the Federal Reserve System.

Cataloguing the agencies created by Congress at the present time for extending credit to the agricultural interests one finds an imposing list: (1) Federal Land banks; (*a*) National Farm Loan associations;

[1] Other obligations of the government might also serve as substitute reserve.

(2) Joint Stock Land banks. Both the above extend long-term credit to the farmers—5 to 40 years; (3) Federal Intermediate Credit banks, extend intermediate credit—6 months to 3 years; (4) National Agricultural Credit corporations, and (5) Rediscount corporations, both of which extend credit for 9 months, with the exception of breeder and dairy loans which are extended for 3 years; (6) national and state banks which can advance types of short-term credit to agricultural interests, subject to certain legal restrictions; (7) Federal Reserve banks, empowered by law to rediscount for member banks certain types of short-term agricultural paper.

In addition to the institutions enumerated above, others have extended credit to the agricultural interests in this country: insurance companies; specialized institutions, such as cattle loan companies; and many other agencies are in existence, which advance substantial amounts to the farmers.

Cattle Loan Companies.—One of the great industries of this country is the cattle business, which is financed in part, either directly or indirectly, by the commercial banks; while two other organizations also help to finance this business, namely, cattle loan companies and livestock commission companies. In practice many of the cattle loan companies are affiliated with some bank, and are thereby enabled to carry on operations which would be impossible for the bank to handle.

Cattle raising is carried on on a large-scale basis and therefore the owner of the herd is as a rule in the market for a large loan. The small banks situated in the cattle communities do not possess sufficient resources to extend more than a fraction of the credit required by cattle borrowers; and in most cases the banking laws restrict the amount which can be extended by a bank to any one person, firm, or corporation. Cattle loan companies therefore have been developed in order to enable the cattle borrowers to raise sufficient amounts, and at the same time to safeguard the purchasers of cattle paper from losses which had been their experience prior to the organization of this type of company.

Cattle loan companies practically act as brokers between the borrowers and those institutions which are in a position to extend such credit. In other words, they act as a clearing house for cattle paper, putting it out in various denominations. This enables the smaller banks of this country, if they so desire, to secure for the portfolio of their institutions paper in convenient amounts representing a fairly stable industry and having adaptable maturities.

Most of the large cattle loan companies are, as said before, closely

affiliated with a banking institution, and generally speaking the officers of the bank are also the officers of the cattle loan companies. The institutions are located in cities adjacent to the cattle loan belt.

In a pamphlet discussing the situation, the writer places the most important cattle loan centers as follows:

Chicago	The Corn Belt and the Northwest as far as western Idaho
Kansas City	Kansas, Oklahoma, Texas, and parts of New Mexico and Colorado
East St. Louis	Southern Illinois, Missouri, Oklahoma, and Texas
St. Paul	The Northwest as far as western Montana
Omaha	Nebraska, South Dakota, Wyoming, Montana, and parts of Iowa
St. Joseph	Kansas, Texas, and eastern Colorado
Sioux City	South Dakota, and parts of Iowa, Nebraska, Minnesota, and Wyoming
Oklahoma City	Oklahoma, Texas, and New Mexico
Fort Worth	Texas and parts of New Mexico
Denver	Colorado and part of Wyoming
El Paso	Parts of Texas, New Mexico, and Arizona
Salt Lake City	Utah and Idaho
Los Angeles	California and part of Arizona
Portland	Washington, Oregon, Idaho, and parts of California, Utah, Nevada, to as far east as Nebraska and South Dakota.[1]

Cattle loan companies extend three general types of credit. These loans are: (1) dairy loans; (2) stocker loans, which in turn are subdivided into three groups, *i.e.*: (*a*) loans for breeding purposes, (*b*) heifer or young stock loans, and (*c*) summer loans; (3) feeder loans.

The first type of loan, the dairy loan, is made to finance the purchase of dairy cows. These loans, in most cases, are for long periods and are usually directly advanced by the local banks.

Stocker loans made to finance breeding stock usually run for 6 months and are frequently renewed. The loans are not considered very liquid and a substantial margin of safety is required, usually about 50 to 60 per cent of the value of the cattle. The security is in the form of a chattel mortgage on the cattle and this covers the offsprings as well, this automatically increasing the safety of the loans. The young stock loans are made to finance the holding of heifers ultimately to be marketed. They run for 6 months and are frequently renewed. Summer loans are found in the West only, and are utilized in financing the purchase of a herd of stock cattle, which is put out on pasture over the summer and most of them disposed of by fall. Therefore they are comparatively short-term loans.

Feeder loans are loans advanced on beef steers, which are in the

[1] NEWMAN, VICTOR A., "An Analysis of the Business Methods of Cattle Loan Banks and Companies," Kansas City, Mo.

final period of feeding prior to their disposal for slaughter. These loans run for periods varying from 3 to 6 months, and are usually not renewed. The amount loaned runs from 80 to 100 per cent of the value of the stock, and the borrowers must possess a high reputation as to character and ability. These loans are popular investments because of the short maturities, and the ease of marketing the cattle, and also due to the fact that the cattle, in putting on weight, increase the security behind the loans.

Credit Analysis Made.—An investigation is made by the cattle loan company concerning the past financial operations of the borrower, and he is required to submit a financial statement not only as a safeguard, but because such paper, to be eligible for discount at the Federal Reserve banks, must be accompanied by a statement of the borrower. The borrower also fills out and returns to the cattle company a *brand sheet,* which identifies the cattle of the borrower, and thus enables the loan company to determine whether this cattle has been hypothecated for other loans, and to ascertain whether the brand is legal and has been properly registered with the county authorities. The companies also inspect the cattle to check up their condition. The borrower, in addition to signing one or more notes, is required, in most cases, to give a chattel mortgage as grantor, and the loan company as grantee. This mortgage is filed with the county clerk.

Cattle Paper.—Cattle paper is considered as a liquid advance upon the security of a life necessity, meat, and representing a well-organized and seasoned industry. The denominations of the notes are convenient, usually ranging from $1,000 to $5,000, the investor receiving with the purchase of a note a *certified trust receipt of chattel mortgage.* The notes are indorsed by the cattle loan companies, which therefore assume the responsibility for prompt payment at maturity. The investing bank should of course investigate carefully the cattle loan company selling the note. Those cattle loan companies which are affiliated with banks are usually considered safest. Banks are prompted to establish cattle loan companies because it facilitates the extension of credit to a large industry by allowing greater freedom of action than would be possible without an affiliated corporation. This is due to the more stringent legal regulations of commercial banking institutions. While the cattle industry, in line with other agricultural industries, has been more or less uncertain during the past few years, it nevertheless represents a field of activity dealing with a necessity of life and therefore affords a means of sound investment of the bank's funds, provided a careful study is made of each particular loan.

It does not appear that the farmer today is suffering from a lack of credit facilities; in fact, the agricultural interests have had especially created for them by the United States government more agencies for extending credit than any other single industry. Yet, at the present time, the agricultural industry in this country cannot be said to be in a healthy state.

Proposals for Solution of Farm Problem.—Various proposals have been put forward by those interested in the solution of the agricultural problem, among which the most seriously considered have been: (1) reduction in acreage; (2) improvement in marketing conditions and methods; (3) revision in immigration laws; (4) subsidy proposals, (5) scientific and diversified farming.

Reduction in Acreage.—The present plight of the American farmer to some extent has been created by the great increase in acreage under cultivation during the period of the World War. The farmers were exhorted by the government to increase the amount of acreage under cultivation and to attempt to increase the yield per acre, which resulted in a great demand for agricultural lands. Farmers were induced, under the guise of patriotism, to increase their holdings at inflated prices, and by mortgaging lands, purchased considerable acreage. With the cessation of hostilities, prices soon commenced to decline and farmers found themselves unable to meet the interest payments due on the mortgages.

Manifestly the logical ways to overcome a situation created by a superabundance of commodities are to either cut down the production or increase the consumption thereof.

Improvement in Marketing Methods.—The statement is often made that the middleman receives a far greater proportion of the profits connected with the distribution of agricultural production than does the producer himself. Undoubtedly the farmer has been loath to cooperate with his fellow farmers in the marketing of his product. Various cooperative marketing associations have been eminently successful in respect to increasing the profits of the agricultural interests. The California Fruit Growers' Exchange, the Florida Citrus Exchange, and others have demonstrated the value of cooperation in the marketing of farm products. Probably much can be done along these lines to increase the return to the agricultural producers.

Revision of Immigration Laws.—There are some who hold that the revision of immigration laws to allow a greater number of immigrants to come into this country would help to solve the problems of the agricultural industry. They hold that not only would cheaper labor

result thereby, but in addition any material increase in the population of this country would result in an increased demand for agricultural production, and the combination of these two factors would result in a substantial increase in the profits accruing to those administering the agricultural industry. On the other hand, it has been often stated that the immigrant who has been attracted to this country during the past decade or so is not interested in farming, and in most cases remains in one of the larger cities, and therefore an increase in the number of immigrants would not affect materially the number of laborers available for agriculture.

Diversified Farming.—Some students of agriculture take the viewpoint that the farmer's position would be materially improved if the practice of diversification of product was undertaken by him. It is contended that diversification of product would eliminate some of the present risks of the one-crop farmer, who is dependent upon the fluctuations in the prices of one commodity.

Thus, for example, if the producer of wheat would also invest substantial sums in livestock, he would not be entirely dependent upon the future price of wheat. Undoubtedly the individual American farmer can do much to improve his position by modernized methods of production. Diversification is one of the ways by which the agricultural industry could be modernized; and combined with scientific farming methods it would reduce the cost of production to the point where the individual farmer would be in a position to receive a greater return. However, one must keep in mind the fact that most authorities who have made intensive studies of the agricultural problem in this country have concluded that overproduction is one of the existing evils, and therefore while the modernizing of agricultural production methods may benefit the individual farmer, the farm industry as a whole would still be in a position of uncertainty because of over-production.

Agriculture Marketing Act.—This bill was passed in June, 1929, and is designed to promote the effective merchandising of agricultural commodities in interstate and foreign commerce, so that the industry of agriculture will be placed on a basis of economic equality with other industries, and to that end to protect, control, and stabilize the currents of interstate and foreign commerce in the marketing of agricultural commodities and their food products:

1. By minimizing speculation.
2. By preventing inefficient and wasteful methods of distribution.
3. By encouraging the organization of producers into effective associations or corporations under their own control for greater unity of effort in marketing

and by promoting the establishment and financing of a farm-marketing system of producer-owned and producer-controlled cooperative associations and other agencies.

4. By aiding in preventing and controlling surpluses in any agricultural commodity, through orderly production and distribution, so as to maintain advantageous domestic markets and prevent such surpluses from causing undue and excessive fluctuations or depressions in prices for the commodity.[1]

Federal Farm Board.—The act created a Federal Farm Board, consisting of eight members appointed by the President of the United States. This board has the following specific powers, under Sec. 5:

1. To promote education in the principles and practices of cooperative marketing of agricultural commodities and food products thereof.
2. To encourage the organization, improvement in methods, and development of effective cooperative associations.
3. To keep advised from any available sources and make reports as to crop prices, experiences, prospects, supply and demand, at home and abroad.
4. To investigate conditions of overproduction of agricultural commodities and advise as to the prevention of such overproduction.
5. To make investigations and reports and publish the same, including investigations and reports upon the following: land, utilization for agricultural purposes, reduction of the acreage of unprofitable marginal lands in cultivation, methods of expanding markets at home and abroad for agricultural commodities and food products thereof, methods of developing by-products of and new uses for agricultural commodities and transportation conditions and their effect upon the marketing of agricultural commodities.

Cooperative Associations.—Cooperative associations handling any agriculture commodity may be invited by the board to form an advisory commodity committee to consist of seven members, of whom at least two shall be experienced handlers or processors of the commodity, to represent such commodity before the board when matters pertaining to that commodity are discussed. The act stipulates that:

Members of each advisory committee shall be selected by the cooperative associations from time to time in such manner as the board shall prescribe. No salary shall be paid to committee members, but the board shall pay each a per diem compensation not exceeding $20 for attending committee meetings called by the board and for time devoted to other business of the committee authorized by the board, and necessary traveling and subsistence expenses, or per diem allowances in lieu thereof, within the limitations prescribed by law for civilian employees in the executive branch of the government. Each advisory committee shall be designated by the name of the commodity it represents, as, for example, the "Cotton Advisory Committee."

[1] *Commercial and Financial Chronicle*, p. 4092, June 22, 1929.

A revolving fund of $500,000,000 is provided by the act and is placed at the disposal of the board, and is available for loans to stabilization corporations.

Stabilization Corporations.—Stabilization corporations are provided to act as marketing agencies for cooperatives, and as central sales agencies for the commodity. These corporations are owned and operated by cooperatives, but under the supervision of the board. Senator Capper describes how the stabilization corporations are to act, using the handling of wheat as an illustration.[1]

The board will ask the wheat cooperatives to name an advisory committee of seven, under regulations to be made by the board. This committee will advise the organization by the cooperatives and recognition by the board of a wheat-stabilization corporation.

This stabilization corporation will be a central sales agency for handling wheat. It can market for its members. It can buy wheat from members or non-members. It will borrow money—perhaps a $100,000,000 or so—from the revolving fund.

It can construct or lease elevators, sell, or hold, or otherwise dispose of wheat.

It is expected to announce its intention of buying a large amount of wheat. If that announcement does not bring the domestic market up to a reasonable figure, it will buy wheat. It can either market it at home or abroad. If it sells abroad at a loss, that loss will come back on the revolving fund.

The Federal Board will retain power to force the sale of the corporation's wheat on the domestic market if a corner that "unduly enhances the prices to the distress of the consumers" is attempted.

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[1] *Commercial and Financial Chronicle*, p. 4093, June 22, 1929.

CHAPTER XXXVII

BANKING TENDENCIES

It is a difficult and somewhat dangerous task to attempt to forecast the course of banking development in the future, but there are certain conditions and forces at work in the United States today which seem to indicate the direction which banking development may take.

1. The United States, a Creditor Nation.—One of the obvious changes of conditions in this country which will affect banking is the recently acquired creditor position of the United States. Prior to the World War the United States was a debtor nation and, as such, paid considerable sums of interest to the leading European countries. It was estimated that foreigners held securities representing investments in this country, of from $4,500,000,000 to $6,500,000,000. The necessity of meeting interest payments on this debt led to the development of American industry of a heavy export trade balance, and also caused American bankers to turn to Europe for financial assistance at certain periods of the year when there was an inadequate supply of bills available for payments to European creditors. The war brought a sudden change in this state of affairs. To finance the war, European nations resold to us a substantial part of their security holdings, and, in addition, borrowed from us extensively. The importance of New York City, in comparison with London, as a monetary center for international financial obligations was greatly enhanced and many neutral countries, which had previously looked to London for the financing of foreign trade, now turned to New York City, where the banks were rapidly acquiring an experience in the handling of an ever-increasing quantity of international trade and financial transactions. The war brought about not only an enormous European debt to the United States, but also resulted in the acquisition by this country of a substantial part of the gold resources of the world. Turning to the war years, from January, 1914, to December, 1918, gold imports into the United States exceeded gold exports by $1,002,420,550,[1] while from August, 1914, until December, 1918, $8,171,976,000 of foreign loans were floated in this

[1] Statistical abstract of the United States, 1919, p. 763.

country.[1] During the period ending with December, 1916, it has been estimated that over 50 per cent of the United States railroad securities held abroad had been returned to this country, together with large quantities of industrial securities.

In the years following the World War, the necessities of European rehabilitation continued to bring about extensive borrowings by Europe from the United States and a continued flow of gold into this country. By 1927, it was estimated that foreign debts to the United States, including government debts, was approximately $24,000,000,000. The interest alone on this enormous debt, calculated at 5 per cent, amounts to $1,200,000,000 a year.

This situation affects American banking policies and practices in a number of important ways.

a. Investment in Foreign Securities.—Although the United States is now a creditor nation, the business interests of this country still demand a substantial annual excess of material exports over imports. Any increase in the import trade is actively discouraged by the imposition of ever-higher tariff rates, and, in consequence, the problem of how Europe is to pay for our exports becomes ever more pronounced. The only possible method seems to be for the United States to lend annually to Europe the sums necessary to enable Europe to purchase our annual excess of exports, and for some years this has been done. For example, during 1926, 1927, and 1928, the United States purchased approximately $4,557,000,000 of foreign securities.[2] Under this method of handling the situation, the problem becomes each year more acute as the interest and principal payments owing by Europe to the United States mount to higher levels. The banking interests in this country have been compelled to familiarize themselves with foreign credits, foreign securities, and the methods of sale of such securities to the American investing public, so that today dealings in foreign securities are a part of the banking and fiscal operations of this country to a degree hitherto unknown.

Some foreign comment upon this situation might be of interest. In the *Monthly Review*, July to August, 1929, of the Midland Bank, Limited, of London, it is said:

. . . . Thus the creditor position of the United States is still being steadily strengthened. By one means or another the process goes on, irrevocably, inevitably, with the sureness almost of a law of nature. Indeed, it is almost a law of nature that if a creditor country takes all possible steps to expand her

[1] Noyes, Alexander D., "The War Period of American Finance," p. 89.

[2] Commerce Year Book, Vol. I, p. 661, 1928.

exports to foreign markets, and at the same time maintains an attitude of active dislike for foreign imports, then her investments abroad must pile up and up indefinitely. If the seller insists on selling and prefers not to buy, there is only one possible result. The buyer must go further into debt—always assuming the new debts are not balanced by the cancellation, with or without the consent of the creditor, of old debts. There is always the bankruptcy court at the end of the road, and it is an interesting speculation how far nations, as economic entities, can in practice go into debt without plugging the wells of accommodation. On the answers given to specific questions arising from this general problem hangs the formulation of a wise, far-seeing policy for American trade.

b. International Importance of New York City.—The enormous importance of this country today as a market for European securities, together with its possession of a substantial supply of the gold reserves of the world, have of necessity enhanced the importance of New York as an international money market, and have imposed obligations on the New York banks, which were hitherto in large measure undertaken by banks in London and other large European capitals. New York banking, and to some extent banking in other financial centers in this country, has therefore taken on an international character, which has resulted in enlarged activities in foreign exchange departments, the opening of correspondent relations with banks in foreign capitals, and the establishment of branches of American banks in foreign countries.

c. United States Participation in Foreign Financial Activities.—The position of isolation of the United States from European affairs is a thing of the past, and the preponderant importance of the United States in international finance today requires the constant participation of American bankers in foreign financial activities, such as the enforcement of the various reparation payment plans, and the establishment and operation of the newly created Bank of International Settlements, at Basle, Switzerland, in which J. P. Morgan & Company is representing the banking interests of this country.

d. Reserve Policies.—The discount and open-market operations of the Federal Reserve banks cannot be dictated solely by domestic business and credit conditions. The international financial position of the United States requires that Federal Reserve policy give due regard to foreign banking conditions. Certain phases of Federal Reserve policy have been influenced by the necessity for aiding foreign countries to rehabilitate their currencies and financial affairs, in order that they might be in a position to purchase larger quantities of American goods, and have a credit position sufficient to enable them to sell securities in

the American markets. To accomplish this, the Federal Reserve system has increased its intimacy and strengthened its connections with the leading central banks of Europe.

2. Business Cycles.—Of recent years, the subject of business cycles has received an enormous amount of attention and study on the part of leading economic and financial writers, and students of business conditions. Briefly the term *business cycle* means the rhythmical or wave-like movement of business from depression to prosperity and back again, recurring with some degree of periodicity. It is not within the scope of this volume to enter into a detailed discussion of business cycles or to attempt to give any explanation thereof, but certain effects of the studies of business cycles on banking policies should be briefly noted.

It is believed that certain conditions exist in each phase of the business cycle, which will cause or bring about the succeeding phase, and that through a careful study of these existing conditions the various phases can be forecast with a fairly high degree of probability. This should affect commercial banking practices in a number of ways. As the business cycle affects the value of securities, the investment policies of commercial banks will be influenced and investment securities will be bought and sold, not haphazardly, but in accordance with a careful study of the probable future developments of business conditions and security prices.

The lending policies of banks and the character of credit investigation should be predicated upon a study of business cycles. During a period of high prosperity, banks are prone to be swept away by the general feeling of optimism, and overlook the fact that if history is to be relied upon, prosperity will not continue at a stated rate forever, without intermediate periods of business depression.

In analyzing credit statements, the banks must consider, in weighing the significance of the current ratio and other ratios, the phase of the business cycle in which the study is made. A current ratio which would be safe in the early days of a period of prosperity, where business activity and prices were increasing, would be perhaps a dangerous ratio at the end of a period of prosperity when conditions were pointing to a period of liquidation and business decline. The analysis of the assets on a financial statement would be made in the light of the period of the cycle involved. To convert Inventory into Accounts Receivable is very advantageous during a period of depression or price decline, but a large inventory may be a source of considerable profit to a business if prices are on the way up. These brief considerations are cited simply

as illustrations of the way in which business cycles should affect the entire range of credit investigation, lending, and investment policies of commercial banks.

As far as the Federal Reserve system is concerned, one of the reasons for its organization was to control to some degree or, at any rate, to ameliorate the effect of business panics and depressions, and one of the important factors of Federal Reserve discount and open-market policy is a study of the phases of the business cycle. Federal Reserve activities are aimed, to a considerable degree, to the curbing of unreasonable expansion of credit which ordinarily marks period of high prosperity, and to the stimulation of credit expansion during periods of business depression. The careful student of business and banking conditions should familiarize himself with the many valuable contributions on the subject of business cycles in the economic literature of today.

3. Commercial Banking and Capital Formation.—In the past, writers on the subject of commercial banking have emphasized the importance of commercial banks as a source of the supply of funds for working capital purposes to the entire or partial exclusion of the part played by commercial banks in furnishing funds for fixed capital for industry. Certain banking studies of recent years, notably a series of articles by H. G. Moulton, appearing in *The Journal of Political Economy*, and a volume by Waldo F. Mitchell, entitled "The Uses of Bank Funds," have emphasized the importance of commercial banks as sources of supply of investment capital. According to Moulton's figures, something over 50 per cent of the total assets of commercial banks find their way into fixed capital, and it is probable that the future will show an even more marked tendency in the same direction.

This movement is hastened by the policy on the part of large corporations to make themselves independent of the banks from the standpoint of current borrowings for working capital purposes. The popularity of common stocks as an investment has enabled many of the corporations to supply themselves with adequate working capital by the sale of their securities in the investment market, so that a large proportion of them not only have no need for current bank loans but have at many periods of the year a substantial excess of cash, much of which was loaned by them in the call market in New York during the recent bull market. This results in a relatively diminished supply of short-term loans and commercial paper for bank investment, and the banks are perforce required to seek an outlet for their funds in other channels. The obvious outlet lies in the security markets so that banks today are investing an ever larger relative proportion of

their assets in stocks, bonds and mortgages, thus invading the investment field at the expense of their strictly commercial activities.

This is a matter of importance, not only in respect to the policies of commercial banks, but in respect to the position of the Federal Reserve System. The Federal Reserve System is predicated on the assumption that the commercial banks are engaged primarily in making commercial loans, and it is only through the medium of commercial loans that the commercial banks have access to the Federal Reserve System and that the Federal Reserve System can exercise any degree of credit control. There is an exception to this in the matter of government bonds, but the preponderant place of government bonds in the finances of today is probably a temporary matter. It resulted from the World War, and the United States today is pledged to a policy of relatively rapid reduction of its outstanding bonded debt, so that from year to year the importance of government bonds in fiscal and banking policies is diminished.

If the commercial banks continue to invest an ever larger proportion of their assets in securities which are not available for rediscount or as collateral for loans from the Federal Reserve System, the relative importance of the Federal Reserve System as an agency of control must, of necessity, decline.

Suggestions have been made for enlarging the activities of the Federal Reserve System by permitting it to lend to member banks on the security of investments, and it is possible that some step analogous to this will be necessary if the Federal Reserve System is to retain its predominant position.

4. Changes in Business Practices.—Business consolidations, resulting in ever larger and larger business units, is the order of the day. Centralized manufacturing plants using mass production methods are supplanting the local factory; and chain-store organizations using mass distribution are taking the place of the local store. The small local utilities are merging into larger companies. These changes, together with the aforementioned practice on the part of many corporations to acquire their working capital by common stock flotations are, of necessity, affecting banking policies and practices in many ways. Small banks, particularly rural institutions, are not equipped, nor are their resources sufficient, to extend adequate credit to the large chain organizations. The latter usually finance themselves through the large city banking institutions if banks are used at all. Thus the local loans which the smaller banks are practically forced to make are not, in many cases, sound loans, such as should be made by institutions with prin-

cipal liabilities consisting of deposits repayable upon the demand of the depositors. The small local borrowers are competing with mail-order houses and chain stores and it is obvious that their position in this competition is rather a precarious one. Certainly, the commercial banker is not justified in risking the resources of his institution by extending credit to enterprises which he knows are in an unfavorable position in the general field of business.

The dilemma of the small bank, particularly in certain sections of the United States which contain many communities dependent upon a single industry such as agriculture, has resulted in numerous failures. In the testimony of the Comptroller of the Currency, appearing before the Committee on Banking and Currency of the House of Representatives, the following statement was made by him concerning the number of bank failures: [1]

THE PERCENTAGE OF BANK FAILURES COMPARED TO THE TOTAL NUMBER OF BANKS WHICH WERE IN EXISTENCE JUNE 30, 1920 TO 1929 INCLUSIVE, BY STATES

In the State of Vermont there were no failures.
In the District of Columbia there were no failures.
In the State of New Hampshire there was 1 failure.
In the State of New Jersey there were 3 failures.
In the State of Massachusetts there were 6 failures, or 1.3 per cent.
In the State of Connecticut there were 3 failures, or 1.4 per cent.
In the State of Maine there were 3 failures, or 1.9 per cent.
In the State of New York there 26 failures, or 2.5 per cent.
In the State of Pennsylvania there were 40 failures, or 2.6 per cent.
In the State of Maryland there were 11 failures, or 3.9 per cent.
In the State of California there were 31 failures, or 4.3 per cent.
In the State of Delaware there were 2 failures, or 4.3 per cent.
In the State of Ohio there were 55 failures, or 4.8 per cent.
In the State of Rhode Island there were 3 failures, or 6.3 per cent.
In the State of Kentucky there were 43 failures, or 7.4 per cent.
In the State of Wisconsin there were 75 failures, or 7.7 per cent.
In the State of Illinois there were 138 failures, or 8.6 per cent.
In the State of Alabama there were 32 failures, or 9.1 per cent.
In the State of Nevada there were 3 failures, or 9.1 per cent.
In the State of Virginia there were 45 failures, or 9.2 per cent.
In the State of Michigan there were 66 failures, or 9.4 per cent.
In the State of Mississippi there were 34 failures, or 9.6 per cent.
In the State of West Virginia there were 34 failures, or 10 per cent.
In the State of Indiana there were 115 failures, or 10.9 per cent.
In the State of Tennessee there were 66 failures, or 12.1 per cent.
In the State of Louisiana there were 34 failures, or 12.7 per cent.

[1] Hearings before the Committee on Banking and Currency, House of Representatives, 71st Congress. H. Res. 141. Vol. 1, Part 1, Feb. 27, 1930, pp. 83 and 84.

In the State of Utah there were 18 failures, or 13.5 per cent.
In the State of Washington there were 56 failures, or 14.2 per cent.
In the State of Oregon there were 43 failures, or 15.5 per cent.
In the State of Kansas there were 223 failures, or 16.5 per cent.
In the State of Missouri there were 296 failures, or 17.9 per cent.
In the State of Texas there were 299 failures, or 18.9 per cent.
In the State of Arkansas there were 95 failures, or 19.5 per cent.
In the State of North Carolina there were 125 failures, or 20.1 per cent.
In the State of Colorado there were 89 failures, or 22.1 per cent.
In the State of Minnesota there were 411 failures, or 27 per cent.
In the State of Oklahoma there were 266 failures, or 27.7 per cent.
In the State of Nebraska there were 339 failures, or 29.3 per cent.
In the State of Iowa there were 528 failures, or 29.9 per cent.
In the State of Arizona there were 27 failures, or 31 per cent.
In the State of Idaho there were 72 failures, or 32.4 per cent.
In the State of Wyoming there were 60 failures, or 30.5 per cent.
In the State of Georgia there were 319 failures, or 43.2 per cent.
In the State of Montana there were 203 failures, or 47.1 per cent.
In the State of North Dakota there were 429 failures, or 47.8 per cent.
In the State of South Carolina there were 227 failures, or 49.2 per cent.
In the State of New Mexico there were 62 failures, or 50 per cent.
In the State of South Dakota there were 394 failures, or 56.8 per cent.
In the State of Florida there were 190 failures, or 71.7 per cent.

5. Branch Banking and Group Banking.—The appalling number of bank failures in this country during the past decade, as revealed in the above testimony of the Comptroller of the Currency, will probably hasten the tendency towards branch banking and group or chain banking. The rural banking institution is hard pressed to place its funds even locally. The local borrowers in the case of these small banks are also stockholders and depositors in the institution. It becomes exceedingly difficult for an official of such a small bank to turn down the loan applications of their stockholders and depositors, even if the banking official is familiar with sound banking practice and, therefore, realizes the risks involved in granting credit to business enterprises which are unfavorably situated.

Branch banking and group banking will tend to enable the bankers to diversify their portfolios and to avoid an overextended excess credit advances to one industry. However, this subject has been discussed in the chapter on Branch Banking and Group Banking and, therefore, it will be pointed out here that a definite tendency exists towards large-scale banking enterprise which inevitably takes the form of either branch banking or group banking.

6. Line of Demarcation between Commercial Banking and Other Types of Banking Becoming Less Clearly Drawn.—The line of demarca-

tion between commercial banking and other types of banking such as, for example, investment banking, is becoming less clearly drawn. The problems of the investment banker, the stock broker, the industrial banker, are more or less becoming the problems of the so-called commercial banker. This tendency is leading to the entrance of the commercial banker directly into these other fields of financial activity. This is daily illustrated by the announcements of large urban banking institutions adding new departments, or organizing affiliated, subsidiary, or associated corporations engaged in financial operations not authorized by the charter of the commercial banking corporation itself. This tendency has been labeled *department-store banking*, because of the many activities carried on by the banking institutions so engaged. It appears as if this tendency will continue because of the relatively lessening amount of genuine commercial banking business called for in this country and the profitableness of the other forms of banking activity. Of necessity, such a development can only take place with those institutions of large resources and this fact alone will tend to encourage amalgamation and consolidation in order that commercial banking institutions can enter the other fields of banking activity.

7. Commercial Banks Indirectly Entering Industry.—The growth in the resources in banking institutions, together with their entrance into other fields of financial activity, has developed a tendency on the part of the banking interests to enter industry itself. This is done by the banks directly or through one of their subsidiary or affiliated organizations and can be illustrated by the announcement of the formation recently of a group of financial agencies to finance the proposed Transatlantic Zeppelin Lines which are expected to spread between Europe and the United States. In a newspaper article it is stated that United Air Craft and the Zeppelin Lines are closely connected with National City Bank interests.[1] In Germany, commercial banks have for a number of years been closely identified with industrial enterprises and have found such connections very profitable.

8. Professionalizing the Banking Business.—The changed position of the United States in the world of finance, the tendency towards large-scale banking, the many economic problems created by changes in business organization, and the developments in the arts and sciences, all place great pressure upon the American banker. This will probably result in a demand for highly trained men who are conversant with sound banking theory and practice in all its phases. Thus, it would appear that the banking business will become professionalized and

[1] *Philadelphia Inquirer*, Mar. 27, 1930.

greater stress will be placed upon the need for a thorough training before one can qualify to become an executive of a banking institution. This should raise the level of the banking profession.

It has frequently been stated that from the standpoint of personnel the banking business today compares with the status of the medical profession, before the requirement of a medical degree, in order to be permitted to practice. The responsibilities resting upon the bankers of this, the wealthiest country of the world, and one which occupies a predominant position among the creditor nations of the world, are great and it is to be hoped that the American bankers will measure up to their responsibilities.

APPENDIX

DIGEST OF CERTAIN PROVISIONS OF STATE LAWS RELATING TO REQUIREMENTS OF BANKS AND TRUST COMPANIES.

State and date of last laws and–or amendments	Minimum number of incorporators	Minimum capital required	Amount of capital required to be paid in before commencing business	Examination as a prerequisite to grant of charter	Double liability	Par value of shares	Charter limit	Directors	
								Minimum	Maximum
Alabama, 1928	No provision.	Banks: $10,000 fully paid, population 1,000 or less. $15,000 fully paid, population 1,000 to 2,500. $25,000, population 2,500 or over. Trust Companies: $25,000, population 5,000 or less. $75,000, population 5,000 to 30,000. $100,000, population 30,000 or over.	All	Yes	No	No provision.	20 years; renewable for like.	No provision.	
Arizona, 1922, amended 1927	3	Banks and Trust Companies. $25,000, population 5,000 or under. $50,000 population 5,000 to 15,000. $100,000 population 15,000 to 50,000. $200,000, population over 50,000.	Fully paid by amendment of 1927	Yes	Yes	No provision.	No provision.	No provision.	
Arkansas, 1925	5	Banks: $10,000, population less than 2,500. $20,000, population 2,500 to 5,000. $25,000, population 5,000 to 10,000. $50,000, population over 10,000. Trust Companies: $50,000, population 40,000 or less. $75,000, population 40,000 to 50,000. $100,000, population over 50,000.	All	Yes	Yes	Not less than $25 nor more than $100. Any par not over $1,000.	No provision.	3	

California, 1927	3	Banks: $25,000, population 5,000 or under. $50,000, population $5,000 to 25,000. $100,000, population 25,000 to 100,000. $200,000, population 100,000 to 200,000. $300,000, population over 200,000. Trust Companies: $100,000, population 200,000 or less. $200,000, population over 200,000.	All	Yes	Yes. Recent case seems to hold unconstitutional—*Commercial and Financial Chronicle*, May 11,1929, p. 3,116.	$25, $50 or $100.	No provision.	3	
Colorado, 1928	3 5	Banks: $25,000 plus 10 per cent surplus. Trust Companies: $50,000, population under 50,000. $100,000, population 50,000 to 150,000. $250,000 population over 150,000.	All	Yes	Treble liability	$100	Any	3	21
Connecticut, 1927	9	Banks and Trust Companies. $50,000, population under 50,000. $100,000, population over 50,000.	All	Yes	No.	Not less than $50.	No provision	No provision.	
Delaware, 1921		Banks and Trust Companies. $25,000 for each place of business.			No				
District of Columbia—National laws in force.									
Florida, 1926	5	Banks: $15,000, population under 3,000. $25,000, population 3,000 to 6,000. $50,000, population over 6,000. Trust Companies: $50,000.	All	Yes	Yes	$100	No provision.	5 5	25

Continued

State and date of last laws and–or amendments	Minimum number of incorporators	Minimum capital required	Amount of capital required to be paid in before commencing business	Examination as a prerequisite to grant of charter	Double liability	Par value of shares	Charter limit	Directors	
								Minimum	Maximum
Georgia, 1919, and amendments to 1927.	5	Banks: $25,000, population under 3,000. $50,000, population over 3,000. Trust Companies: $100,000, fully paid.	60 per cent, not less than $15,000 in cash, remainder in 1 year.	Yes	Yes	$100	30 years renewal privileges.	3	25
Idaho, 1925, amended 1927.	5	Banks: $25,000, population under 3,000. $50,000, population 3,000 to 6,000. $100,000, population over 6,000, plus 10 per cent surplus in all cases. Trust Companies: $50,000, population under 6,000. $100,000, population, over 6,000; plus 10 per cent surplus in all cases.	All	Yes	No	No provision.	No provision	5	
Illinois, 1924.	5, population 10,000 or less; 10, population 10,000 to 25,000; 15, population 25,000 to 50,000; 20, population 50,000 to	Banks including those with trust powers. $25,000, population under 5,000. $50,000, population 5,000 to 10,000. $100,000, population 10,000 to 50,000. $200,000, population over 50,000.	All	Yes	Yes	$100	Any	3	21

	100,000; 25, population over 100,000.								
ndiana, 1921.	5	Banks: $25,000. Trust Companies: $25,000, population less than 25,000. $50,000, population 25,000 to 50,000. $100,000, population over 50,000.	50 per cent at organization, balance within 6 months. All where stock does not exceed $100,000.	Yes	Yes	$100	20 years	5 6	
Iowa, 1929.	5	Banks and Trust Companies. $25,000, population under 3,000. $50,000, population 3,000 to 6,000. $100,000, population over 6,000.	All		Yes	$100 or less.	20 years.	5	
˹ansas, 1927.	5	Banks: $20,000, towns and cities of third class. $30,000, cities of 2nd class. $50,000, cities of first class. Trust Companies: Not less than $100,000; not more than $1,000,000.	All $20 per cent; balance within 6 months.	Yes	Yes	$100	Any	5	25
Kentucky, 1926.	5 7 7	Banks: $15,000, population under 50,000. $100,000, population over 50,000. Banks may exercise trust powers if capital and surplus is $80,000. Trust Companies: $15,000, population under 40,000. $100,000, population 40,000 to 100,000. $200,000, population over 100,000. Combined banks and trust: $30,000, population under 25,000. $50,000 population over 25,000.	50 per cent; balance within 1 year. All	Yes	Yes	No provision.	No provision.	No pro	vision.

Continued

State and date of last laws and–or amendments	Minimum number of incorporators	Minimum capital required	Amount of capital required to be paid in before commencing business	Examination as a prerequisite to grant of charter	Double liability	Par value of shares	Charter limit	Directors	
								Minimum	Maximum
		Banks:							
Louisiana, 1923.	5	$15,000, population under 3,000. $50,000, population 3,000 to 30,000. $100,000 population over 30,000.	50 per cent; remainder in 90 days.	Yes	No	No provision.	99 years.	5	30
		Trust Companies:						If capital, surplus, and undivided profits exceed $2,000,000 may have 5 more directors for each $1,000,000 excess.	
	5	$50,000, population under 30,000. $100,000, population over 30,000.	All						
		Banks and Trust Companies:							
Maine, 1927.	5	$25,000, population under 5,000. $50,000, population 5,000 to 10,000. $75,000, population 10,000 to 20,000. $100,000, population 20,000 to 30,000. $150,000, population over 30,000.	All. As to minimum, one-third of authorized stock must be subscribed for.	Yes	Yes	$100	Perpetual	5	
		Banks:							
Maryland, 1927.	5	$25,000, population under 1,500. $35,000, population 1,500 to 3,500. $40,000, population 3,500 to 5,000. $45,000, population 5,000 to 10,000. $65,000, population 10,000 to 50,000. $100,000, population 50,000 to 150,000. $200,000, population over 150,000.	All	Yes	Yes	Not less than $10.	Perpetual	5	
		Trust Companies:							
	11	$100,000, population under 25,000.						11	30

		$150,000, population 25,000 to 100,000. $200,000, population 100,000 to 250,000. $500,000, population over 250,000.						
Massachusetts, 1926.	5	Banks: $50,000, population less than 10,000. $100,000, population 10,000 to 100,000. $200,000, population over 100,000.			Yes			
	15	Trust companies: Same as above.	All	Yes	Yes	$100	No provision.	7
Michigan, 1927.	5	Banks: $20,000, population 1,500 or less. $25,000, population 1,500 to 6,000. $50,000, population 6,000 to 20,000. $100,000, population 20,000 to 110,000. $250,000, population over 110,000. Deposits exceeding $5,000,000 not less than $400,000 capital.	50 per cent and monthly instalments of 10 per cent.	Yes	Yes	$100	30 years and extension of not over 30 years.	5
	7	Trust Companies: $150,000, population under 100,000. $300,000 and not more than $5,000,000, population over 100,000.	50 per cent; balance in 6 months.					7
Minnesota, 1927.	3	Banks: $10,000 plus $2,000 surplus, population under 500. $20,000 plus $4,000 surplus, population 500 to 1,000. $25,000 plus $5,000 surplus, population $1,000 to 5,000. $40,000 plus $8,000 surplus, population 5,000 to 100,000. $50,000 plus $10,000 surplus, population over 100,000.	All	Yes	Yes	Not less than $1; not more than $100.	Any	3
		Trust Companies: $50,000, population under 25,000. $75,000, population 25,000 to 100,000. $100,000, population 100,000 to 200,000. $200,000, population over 200,000. Maximum capital, $2,000,000.	All up to $200,000.					

Continued

State and date of last laws and–or amendments	Minimum number of incorporators	Minimum capital required	Amount of capital required to be paid in before commencing business	Examination as a prerequisite to grant of charter	Double liability	Par value of shares	Charter limit	Directors	
								Minimum	Maximum
Mississippi, amended to 1927.	3	Banks: $10,000, population under 1,000. $15,000, population 1,000 to 2,500. $25,000, population 2,500 to 6,000. $35,000, population 6,000 to 10,000. $50,000, population over 10,000. Trust Companies: $25,000.	All	Yes	Yes	$50 or $100	50 years.	3	
Missouri, 1919.	5	Banks: $10,000, population under 3,000. $25,000, population 3,000 to 15,000. $50,000, population 15,000 to 25,000. Trust Companies: $50,000, population under 25,000. $100,000, population 25,000 to 100,000. $200,000, population over 100,000.	One half plus amount of surplus and fixtures. Can not own banking house until capital is paid in full; balance in 1 year.	Yes	No	Not less than $100	Any person named in charter not over 50 years; if no period is named, then 20 years.	5	30
Montana, 1921.	3	Banks: 20,000. Trust Companies: $100,000 minimum. $10,000,000 maximum.	All $100,000 fully paid; balance on call or when directors determine.	Yes	Yes	$100	Not over 50 years.	3	25

Nebraska, 1925	3	Banks: $25,000, population under 2,000. $35,000, population 2,000 to 5,000. $50,000, population 5,000 to 25,000. $100,000, population 25,000 to 100,000. $200,000, population over 100,000. Trust Companies: $25,000, population under 10,000. $50,000, population 10,000 to 50,000. $100,000, population 50,000 to 100,000. $200,000, population over 100,000.	All	Yes	Yes	No provision.	No provision.	3	15
Nevada, 1927.	3	Banks, including those with trust power: $25,000.	All	Yes	Yes	$100	Not over 50 years.	3	
New Hampshire, 1925.	10	Banks and Trust Companies: $25,000, population under 4,000. $50,000, population 4,000 to 10,000. $100,000, population 10,000 to 50,000. $200,000, population over 50,000. Cannot exceed $500,000.	All plus a surplus of 20 per cent.	Yes	Yes	$100	No provision.		
New Jersey, 1927.	7 7	Banks: $50,000. Trust Companies: $100,000.	All	Yes	No	$100 Not less than $25 or multiples thereof.	Any	5	
New Mexico, 1929.	 5	Banks: $25,000 plus 20 per cent surplus. Trust Companies: $100,000.	All	Yes	Yes	$100	No provision. 50 years.	3	
New York, 1928.	5	Banks: $25,000, population under 2,000. $50,000, population 2,000 to 30,000. $100,000, population over 30,000.	All	Yes	Yes*	No provision.	Perpetual or less.	5 Capital $5,000,000 or more. 5	30 40
	7	Trust Companies: $100,000, population under 25,000. $150,000, population 25,000 to 100,000. $200,000, population 100,000 to 250,000. $500,000, population over 250,000.					Perpetual	7 Capital $5,000,000 or more. 7	30 40

Continued

State and date of last laws and–or amendments	Minimum number of incorporators	Minimum capital required	Amount of capital required to be paid in before commencing business	Examination as a prerequisite to grant of charter	Double liability	Par value of shares	Charter limit	Directors	
								Minimum	Maximum
North Carolina, 1927.	5	Banks, including those with trust powers: $25,000, population under 3,000. $30,000, population 3,000 to 10,000. $50,000, population 10,000 to 25,000. $100,000, population over 25,000.	All	Yes	Yes	$50 or $100.	Perpetual or less.	No provision.	
North Dakota, 1927	3	Banks: $15,000, population under 1,000. $20,000, population 1,000 to 2,000. $30,000, population 2,000 to 3,000. $35,000, population 3,000 to 4,000. $40,000, population 4,000 to 5,000. $50,000, population over 5,000.	All	Yes	Yes	$100	25 years.	No provision.	
	9	Trust Companies: $100,000.	$50,000 paid in; balance within 2 years.					9	15
Ohio, 1925.	5	Banks: $25,000, population under 10,000. $50,000, population over 10,000. Trust Companies: $100,000 plus capital required for a commercial bank if both businesses are to be transacted.	All	Yes	Yes	$100	No provision.	5	

Oklahoma, 1926.	3	Banks: $10,000, population under 500. $15,000, population 500 to 1,500. $25,000, population 1,500 to 6,000. $50,000, population 6,000 to 20,000. $100,000, population over 20,000.	All	Yes	Yes	$100	25 years.	3	21
	5	Trust Companies. $25,000, population under 10,000. $100,000, population 10,000 to 25,000. $200,000, population over 25,000, not more than $10,000,000.	50 per cent; balance in 6 months.				50 years or perpetual.	5	25
Oregon, 1927.	3	Banks: $15,000, population under 1,000. $25,000, population 1,000 to 3,000. $50,000, population 3,000 to 20,000. $200,000, population over 75,000. Trust Companies: $15,000, population under 1,000. $25,000, population 1,000 to 3,000. $50,000, population 3,000 to 20,000. $200,000, population over 75,000.	50 per cent: balance in 6 months.	Yes	Yes	No provision.	Perpetual or less.	3	
Pennsylvania, 1929.	3	Banks: $25,000, population under 5,000. $50,000, population over 5,000.	50 per cent; monthly instalments 10 per cent.	Yes	Yes	Any	20 years.	5	13
		Trust Companies: $125,000.	All		No (see text)		Any	No provision.	
Rhode Island, 1925.	15	Banks and Trust Companies: No provision.	All	Yes	No	No provision.	No provision.	No provision.	
South Carolina, 1923.	2	Banks: No provision. May have trust powers if capital of $25,000.	20 per cent. All	No provision.	Yes, but only to depositors, not other creditors.	No provision.	Perpetual or less.	Any	

Continued

State and date of last laws and–or amendments	Minimum number of incorporators	Minimum capital required	Amount of capital required to be paid in before commencing business	Examination as a prerequisite to grant of charter	Double liability	Par value of shares	Charter limit	Directors	
								Minimum	Maximum
South Dakota, 1927.	5	Banks: $15,000, population under 1,500. $20,000, population 1,500 to 2,500. $25,000, population 2,500 to 5,000. $50,000, population over 5,000.	All plus $10 per share surplus.	Yes	Yes	$100	20 years; renewal privileges.	5	
	7	Trust Companies: $50,000, population under 5,000. $100,000, population over 5,000.	All				Perpetual or less.	7	
Tennessee, 1927.		Banks and Trust Companies: $10,000, population under 1,000. $25,000, population 1,000 to 2,500. $50,000, population 2,500 to 5,000. $75,000, population 5,000 to 20,000. $100,000, population 20,000 to 50,000. $200,000, population over 50,000.	All	Yes	Yes	No provision.	No provision	No provision.	
Texas, 1927.	5	Banks: $17,500 population under 800. $25,000, population 800 to 10,000. $50,000, population 10,000 to 20,000. $100,000, population over 20,000. Not to exceed $10,000,000. Bank and Trust Companies: $50,000, population under 20,000. $100,000, population over 20,000. Not to exceed $10,000,000.	All	Yes	Yes	$100	Not over 50 years.	5	25

Utah, 1927.	3	Banks: $25,000, population under 5,000. $50,000, population 5,000 to 25,000. $75,000, population 25,000 to 50,000. $100,000, population over 50,000. Trust Companies: $25,000. $100,000 in cities of the first class.	50 per cent in cash; balance 10 per cent per month. All	Yes	Yes	No provision.	No provision.	No provision.	
Vermont, 1927.	15	Banks and Trust Companies: No provision.	All	Yes	Yes	No provision.	No provision.	No provision.	
Virginia, 1926.	3	Banks and Trust Companies: $15,000, population less than 2,000. $25,000, population over 2,000.	50 per cent; balance in monthly instalments of 10 per cent. Minimum paid in, $15,000.	Yes	No	No provision.	Perpetual or less.	5	
Washington	5	Banks: $15,000, population less than 2,000. $25,000, population 2,000 to 5,000. $50,000, population 5,000 to 25,000. $100,000, population 25,000 to 100,000. $150,000, population over 100,000. Trust Companies: $50,000, population under 25,000. $100,000, population 25,000 to 100,000. $200,000, population over 100,000.	All plus 10 per cent undivided profit and surplus.	Yes	Yes	$100	Not over 50 years.	5 Capital $50,000 or less. 3	
West Virginia	5	Banks: $25,000, requirement same as National Bank. Trust Companies: $100,000.	All	Yes	Yes	$25 or multiples thereof.	50 years	5	

State and date of last laws and–or amendments	Minimum number of incorporators	Minimum capital required	Amount of capital required to be paid in before commencing business	Examination as a prerequisite to grant of charter	Double liability	Par value of shares	Charter limit	Directors	
								Minimum	Maximum
Wisconsin, 1927.	7	Banks: $25,000, population less than 5,000. $35,000, population 5,000 to 10,000. $50,000, population 10,000 to 200,000. $200,000, population over 200,000. Trust powers to bank if they have amount of capital necessary for a national bank to do a fiduciary business. Trust Companies: $50,000, cities under 100,000. $100,000, cities over 100,000; not to exceed $5,000,000.	All	Yes	Yes	No provision.	Any	5	
Wyoming, 1927.	5	Banks and Trust Companies: $15,000, population under 1,000. $25,000, population 1,000 to 4,000. $50,000, population 4,000 to 6,000. $100,000, population over 6,000.	50 per cent; balance in 6 months.	Yes	Yes	$100	50 years.	5	9

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